SUPREME COURT, U. S.
FILED
APR 25 1977
MICHAEL RODAK, JR., CLERK

APPENDIX

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Appellant*,

v.

UNITED STATES OF AMERICA, *Appellee*.

ON PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

VOLUME I

(Pages 1-312)

PETITION FOR WRIT OF CERTIORARI FILED NOVEMBER 3, 1976
CERTIORARI GRANTED FEBRUARY 22, 1977

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Appellants*

v.

UNITED STATES OF AMERICA, *Appellee*

Petition for Writ of Certiorari Filed November 3, 1976

Certiorari Granted February 22, 1977

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FRANK LYON COMPANY

v.

THE UNITED STATES OF AMERICA

Date	Filings—Proceedings
9-27-73	Complaint filed. Summons issued and handed marshal for service.
10-9-73	Mar. det. on service on summons, by serving Jane Thompson, Secretary, on 10-1-73, and by certified letter to the Attorney General's Office, 9-27-73.
11-26-73	Answer filed. C/S.
8-13-74	Order setting pre-trial conference on Wed., Sept. 18, 1974, 11:00 a.m.
9-16-74	Stipulation filed by both parties.
9-20-74	Pre-Trial Order by J. Eisele ordering this case set for trial to the Court at 9:30 a.m. Tuesday, November 26, 1974; Deft. USA filed a demand for jury trial; it now desires to waive trial by jury; the case is therefore transferred to the non-jury docket; Pltf. has filed a pretrial brief with the Court. Deft. should provide the Court with citations of authority upon which it is relying; All discovery must be completed not later than November 8, 1974; No discovery will be permitted thereafter except to prevent manifest injustice; The Court will read the stipulation and all exhibits before trial, with reference to deft's exhibits there is no agreement that they are accurate or that they would represent the tax advantage to the Pltf. if his position were adopted, however, deft. will not be required to present the testimony of an agent who prepared them.
10-22-74	Deposition of Edward M. Penick filed by Court Reporter, taken Tuesday, September 17, 1974.
10-24-74	Deposition of Frank Lyon taken Sept. 12, 1974, Little Rock.

10-24-74—Deposition of E. Ralph Cotham taken 9-12-74, Little Rock.

11-15-74—Deposition of C. V. Barnes taken 11-4-74, Little Rock.

11-26-74—Trial to Court before Judge Eisele, 9:32 a.m.-6:00 p.m. continued.

11-27-74—Trial resumed 9:00 a.m.-5:07 p.m. After completion of testimony, Court stated some findings from bench: Frank Lyon is owner of building; it is highly improbable that Worthen will exercise option at end of 11th year or any other option period; there is no loan here, even if finally should determine Worthen owns the building. Simultaneous briefs due December 20; each party may respond by January 7, 1975.

12-3-74—Marshal's Return of Service on Frank Lyon, personally 11-26-74.

12-6-74—Marshal's Return of Service on Edward M. Penick, personally 11-22-74.

12-20-74—Deft's. Supplemental Memorandum of Fact and Law.

12-23-74—Supplemental Stipulation by parties.

1-7-75—Reply Brief—Deft.

5-21-75—Memorandum Letter Opinion, J. Eisele.

5-27-75—Excerpted Testimony filed by Reporter Fant (fr 11-27-74).

5-27-75—Excerpted Remarks filed by Reporter Fant (fr 11-27-74)

6-3-75—Original transcript of remarks made by the Court at close of trial led by Scott P. Crampton, Asst. Atty. Gen'l.

6-11-75—Supplementary Findings of Fact and Conclusions of Law filed by Judge Eisele.

6-11-75—Judgment pursuant to findings of fact and conclusions of law filed by Judge Eisele, entering judgment in favor of plaintiff in the following amounts with interest from dates indicated:

$32,624.32 with interest thereon from March 15, 1969;

$231,871.26 with interest thereon from March 15, 1970;

$43,790.84 with interest thereon from April 19, 1973.

8-5-75—Orig. & 1 copy of Vols. I & II of transcript of trial filed by Reporter Fant.

8-11-75—Notice of Appeal for judgment of 6-11-75 by U.S. Dist. Court to U.S. Court of Appeals for the 8th Circuit: Certified copy of N/A & 2 cert. copies of docket entries to 8th Cir.; copies to U.S. Atty., appellant—J. Gaston Williamson, atty. for appellee—& to Carolyn Fant, Court Reporter.

GENERAL DOCKET

United States Court of Appeals
For the Eighth Circuit

Appeal from Eastern District of Arkansas

Case No. 75-1615

Frank Lyon Company, Appellee,
vs.
The United States of America, Appellant.

Date 1975	Filings—Proceedings	Filed
Aug. 13	Docketed appeal	
Aug. 13	Cert. copies Notice of Appeal, Docket Entries of D.Ct.	(1)

Aug. 18—Appearance appellee (2)

Aug. 19—Appearance appellant (3)

Aug. 25—Appearance appellant (4)

Sept. 19—Motion appellant for extension of time to file appendix and brief (5)

Sept. 19—Order: Appellant may have thru October 22 to serve and file appendix and opening brief (6)

Oct. 24—Appendix (vol. 1 & 2) w/service (7)

Oct. 24—Brief appellant w/service (8)

Oct. 24—Four copies exhibit volume

Oct. 28—Appearance appellant (9)

Nov. 25—Order: Appellee may have thru December 4 to serve and file brief (10)

Dec. 3—Brief appellee (11)

Dec. 3—Affidavit of service w/brief appellee (12)

Dec. 8—Submitted to screening panel

Dec. 19—Mo applnt for ext to file reply brief (13)

Dec. 23—Order: Appellant granted to January 2 to serve and file reply brief (14)

1976

Jan. 5—Reply brief appellant w/ser (15)

Jan. 21—Transferred to February session

Feb. 13—Appearance for appellee (16)

Feb. 13—Argued and submitted to Judges Bright, Henley, Regan. Gary Allen, Dept. of Justice for appellant; C. J. Giroir, Jr. for appellee; concluded by Mr. Allen. Recorded

May 26—Opinion by Judge Bright (Published) (17)

May 26—Judgment: Judgment of district court is reversed and remanded to district court for proceedings consistent with opinion (18)

June 4—Appellee's bill of costs (19)

June 4—Appearance for appellee (20)

June 4—Mo appellee for ext to file pet for reh/reh en banc (21)

June 4—Order: Appellee may have thru June 18 to file petition for rehearing (22)

June 17—Petition of appellee for rehearing en banc and rehearing (23)

Aug. 6—Order: Petition of appellee for rehearing en banc is denied (24)

Aug. 6—Order: This court directs that our opinion be modified; petition for rehearing of Frank Lyon Co. is denied (Printed, Published) (25)

Aug. 16—Mandate issued

Aug. 19—Receipt for mandate (26)

Nov. 8—Notice of filing of petition for writ of certiorari in Supreme Court as Case No. 76-624 (as of 11/3/76) (27)

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Mar. 3—Order of Supreme Court in Case No. 76-624 granting certiorari (28)

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Complaint

(Filed September 27, 1973)

The plaintiff, Frank Lyon Company, for its cause of action against the defendant, United States of America, states:

1. Plaintiff is, and at all times mentioned in this complaint was, a corporation organized and existing under the laws of the State of Arkansas with its principal place of business in Little Rock, Pulaski County, Arkansas.

2. This is an action for the recovery of internal revenue taxes, with interest thereon, erroneously and illegally assessed and collected. Jurisdiction is conferred upon this Court by Title 28, United States Code, Sec. 1346(a)(1), as amended.

3. Plaintiff filed its income tax return for the calendar year 1969 with the Internal Revenue Service Center, in Austin, Texas, and paid the tax reported due thereon. Following an examination of said return, the Commissioner of Internal Revenue assessed an income tax deficiency against plaintiff for 1969 as follows:

Tax Deficiency	Interest	Total Assessment
$261,063.34	$48,339.63	$309,402.37

Plaintiff paid said deficiency assessment to the Internal Revenue Service Center, in Austin, Texas, on April 19, 1973.

4. Of the total deficiency assessment for 1969, $24,466.98, together with interest in the amount of $4,548.79, was attributable to adjustments not contested by the taxpayer. The remaining deficiency assessment was attributable to the Commissioner's erroneous determinations that plaintiff was not the owner of the Worthen Bank Building in Little Rock, Arkansas, and was not entitled to deduct certain expenses attributable to said building as set forth in plaintiff's claim for refund, a copy of which is attached hereto as Exhibit "A" and incorporated herein by reference.

5. On July 20, 1973, plaintiff filed with the Internal Revenue Service Center, in Austin, Texas, a claim for refund (Exhibit "A") of income tax for 1969 in the amount of $236,596.36, plus interest paid thereon in the amount of $43,790.84, no part of which has been repaid to plaintiff. As grounds for recovery, some of which are stated in the alternative, plaintiff incorporates herein by reference the averments contained in its claim for refund for 1969.

6. By certified letter dated August 22, 1973 from the Internal Revenue Service Center in Austin, Texas, plaintiff received statutory notice that its claim for refund for 1969 had been disallowed in full. A copy of said letter is attached hereto as Exhibit "B".

WHEREFORE, plaintiff prays for judgment against defendant for income taxes overpaid for 1969 in the amount of $236,596.36, plus interest assessed thereon in the amount of $43,790.84, for a total of $280,387.20, together with its costs and interest as provided by law, and for all other relief to which plaintiff is entitled.

/s/ J. GASTON WILLIAMSON
J. Gaston Williamson
720 West Third Street
Little Rock, Arkansas 72201
Attorney for Plaintiff

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Answer

[Filed November 26, 1973]

The defendant, United States of America, by its attorney, W. H. Dillahunty, United States Attorney for the Eastern District of Arkansas, for its answer to the complaint herein admits, denies, and alleges as follows:

1. Admits the allegations contained in paragraph 1.

2. Admits the allegations contained in paragraph 2, except denies that any tax or interest was erroneously and illegally assessed and collected.

3. Admits the allegations contained in paragraph 3, except alleges that the total deficiency assessment was $309,402.97, rather than the amount alleged in the complaint and further alleges that the Internal Revenue Service received payment of this amount on April 20, 1973, rather than the date alleged.

4. Is presently without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 4, except denies that any determination of the Commissioner was erroneous and further denies each and every allegation contained in the claim for refund unless specifically admitted herein, except admits that a copy of the claim for refund was attached to the complaint as Exhibit A.

5. Admits the allegations contained in paragraph 5, except alleges that plaintiff's claim for refund was received on July 24, 1973, rather than the date alleged in the complaint and denies each and every allegation contained in the claim for refund unless specifically admitted herein.

6. Admits the allegations contained in paragraph 6.

Wherefore, defendant prays for judgment in its favor, allowing the defendant its costs, and for such other relief as this Court may deem just and proper.

W. H. Dillahunty
United States Attorney

By:
Assistant United States Attorney

Demand For Jury Ttial

Defendant demands a trial by jury of all issues of fact arising out of this action.

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Stipulation

[Filed September 16, 1974]

It is hereby stipulated by and between the parties hereto that for the purpose of this case the following facts may be taken as true, subject to the right of either party to object to the admission of such facts in evidence on the grounds of materiality or relevance; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. This is an action for the recovery of Internal Revenue taxes, with interest thereon. Jurisdiction is conferred upon this Court by Title 28, United States Code, Section 1346(a)(1) as amended.

2. The plaintiff filed its income tax return for the calendar year 1969 with the Internal Revenue Service Center, in Austin, Texas, and paid the tax reported due thereon. Following an examination of plaintiff's return, the Commissioner of Internal Revenue determined that plaintiff was "not the owner for tax purposes of any portion of the Worthen Building" and therefore disallowed the following items of income and expenses related to that building:

Item	Amount
Rental income from Worthen Bank	$(48,527.01)
Depreciation on building	51,618.79
Interest paid to First National City bank on interim financing	403,899.54
Legal expense	33,351.05
Title insurance	10,140.00
Audit expense	3,475.00
Telephone and travel	801.16
Interest expense to New York Life	40,162.50
Accrued interest income on investment	2,298.15
Total	$497,219.18

Based upon those adjustments, the Commissioner of Internal Revenue assessed against plaintiff an income tax deficiency of $236,596.36, together with interest in the amount of $43,790.84, making a total deficiency assessment of $280,387.20.

3. The amounts sued for in the complaint were timely assessed by the Commissioner of Internal Revenue, and payment of the deficiency assessments was made by the plaintiff on the dates disclosed in the claim for refund. Claim for refund was timely filed, and the claim for refund was denied by the Commissioner of Internal Revenue. The action filed by plaintiff for the recover of the amount set forth in its claim for refund was begun within the time permitted by Title 26, United States Code, Section 6532 (a)(1).

4. Attached hereto are copies of the following documents which may be introduced by plaintiff during the trial of this case in lieu of the original copies of said documents:

PX 1. Letter dated August 26, 1967 from Edward M. Penick, President of Worthen Bank & Trust Company, to O. O. Wyrick, Vice President of Federal Reserve Bank of St. Louis.

PX 2. Letter dated September 1, 1967 from Edward M. Penick to O. O. Wyrick.

PX 3. Letter dated September 12, 1967 from Edward M. Penick to O. O. Wyrick.

PX 4. Letter dated September 13, 1967 from O. O. Wyrick to Edward M. Penick.

PX 5. Letter dated September 1, 1967 from Edward M. Penick to H. C. Adams, Commissioner of State Bank Department.

PX 6. Letter dated September 5, 1967 from H. C. Adams to Edward M. Penick.

PX 7. Letter dated September 12, 1967 from Edward M. Penick to H. C. Adams.

PX 8. Letter dated September 13, 1967 from H.C. Adams to Edward M. Penick.

PX 9. Sale and Leaseback proposal dated September 28, 1967 of Goldman, Sachs & Co.

PX 10. Revised Sale and Leaseback proposal dated October 27, 1967 of Stephens, Inc.

PX 11. Letter dated October 30, 1967 from plaintiff to Worthen confirming verbal proposal of plaintiff.

PX 12. Comparison of financing plans of plaintiff, Stephens, Inc. and Goldman, Sachs & Co.

PX 13. Specification for Sale-Leaseback of Worthen Bank Building dated October 31, 1967.

PX 14. Letter dated November 1, 1967 from plaintiff to Worthen containing plaintiff's proposal number 2.

PX 15. Comparison of financing plans dated November 2, 1967.

PX 16. Letter dated November 30, 1967 from Alan W. Peters, Vice President of First National City Bank to Edward M. Penick.

PX 17. Letter dated December 18, 1967 from Richard W. Baker, Jr., Vice President of New York Life Insurance Company to Frank Lyon Company.

PX 18. Ground Lease dated May 1, 1968 between Worthen Bank & Trust Company, as Lessor, and Frank Lyon Company, as Lessee.

PX 19. Building Lease dated May 1, 1968 between Frank Lyon Company, as Lessor, and Worthen Bank & Trust Company, as Lessee.

PX 20. Note Purchase Agreement dated May 1, 1968 between Frank Lyon Company and New York Life Insurance Company.

PX 21. Building Loan Agreement dated May 14, 1968 between Frank Lyon Company and First National City Bank.

PX 22. Note for $7,000,000 dated May 14, 1968 from Frank Lyon Company to First National City Bank.

PX 23. Building Loan Mortgage dated May 14, 1968 from Frank Lyon Company and Worthen Bank & Trust Company to First National City Bank.

PX 24. Assignment dated May 14, 1968 from Frank Lyon Company to First National City Bank.

PX 25. Sales Agreement dated May 19, 1968 between Frank Lyon Company, as purchaser, and Worthen Bank Trust Company, as seller.

PX 26. Note dated December 1, 1969 for $7,140,000.00 from Frank Lyon Company to New York Life Insurance Company.

PX 27. First Deed of Trust dated December 1, 1969 from Frank Lyon Company and Worthen Bank Trust Company to New York Life Insurance Company.

PX 28. Assignment dated December 1, 1969 from Frank Lyon Company to New York Life Insurance Company.

PX 29. Consent and Agreement dated December 1, 1969 of Worthen Bank Trust Company to New York Life Insurance Company.

PX 30. Specimen letter dated September 11, 1969 from Worthen to plaintiff requesting partial payment toward purchase price of building.

PX 31. Specimen letter dated September 15, 1969 from plaintiff to First National City Bank requesting disbursement under interim loan.

PX 32. Specimen bank statement of plaintiff's account at First National City Bank with specimen and checks and credit ticket attached.

PX 33. Comparative consolidated balance sheets of Frank Lyon Company and subsidiaries as of December 31, 1968 and 1969.

PX 34. Comparative consolidated statement of income for calendar years 1968 and 1969.

5. Attached hereto are copies of the following documents which may be introduced by defendant during the trial of this case in lieu of the original copies of said documents:

DX 1. Schedule reflecting equity interest in land and buildings of Worthen Bank Trust Company 1969.

DX 2. Schedule reflecting cash flow to Frank Lyon Company on Worthen Bank Building lease.

DX 3. Schedule reflecting Frank Lyon Company loss from rental operation of Worthen Bank Building.

DX 4. Schedule reflecting gain on sale of Worthern Building by Frank Lyon Company if 1980 option is exercised.

DX 5. Schedule reflecting tax consequences versus economic gain of Frank Lyon Company from sale of Worthern Bank Building if 1980 option exercised.

6. Either party may introduce additional exhibits if copies thereof are furnished to opposing counsel and a list thereof furnished to the Court at least 15 days before the trial of this case.

/s/ J. G. WILLIAMSON
J. G. Williamson
720 West Third Street
Little Rock, Arkansas 72201
Attorney for Plaintiff
W. H. DILLAHUNTY
United States Attorney

By: /s/ EUGENE C. SAYRE
Eugene C. Sayre
Attorney, Tax Division
Department of Justice
8E2 Federal Office Bldg.,
1100 Commerce Street
Dallas, Texas 75202

[Exhibits contained in a separate Exhibit Volume]

IN THE UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

Supplemental Stipulation

[Filed December 23, 1974]

It is hereby stipulated by and between the parties hereto that for the purposes of this case the following facts may be taken as true:

1. Due to an oversight by the accountant who prepared plaintiff's income tax return for 1969, no portion of the following items of expense paid in 1969 and attributable to the Worthen Building were deducted on plaintiff's federal income tax for 1969:

Date Paid	Payee and Description	Amount
11-31-69	1st. Nat'l. City Bk., int. on interim loan	$49,583.33
12- 3-69	SW Bell Tel. Co., interim loan	1.60

12- 8-69	Beach Abstract Co., title ins. interim loan	3,405.50
12- 9-69	Parkin Prtg., printing Bldg. Loan Agreement	216.77
12-23-69	House, Holmes & Jewell, atty. fee NYL loan	2,830.45
12-23-69	Cotham, Wyman & Howland, fee re interim loan	1,750.00
12-31-69	Rose Law Firm, atty. fee NYL loan	4,000.00

2. The total interest paid by plaintiff on the interim loan from First National City Bank and the calendar year in which it was paid or accrued was as follows:

Paid or accrued in 1968	$ 40,411.90
Paid or accrued in 1969	413,070.97
Total	$453,483.87

3. The travel and telephone expenses paid by plaintiff attributable to the Worthen Building and deducted on plaintiff's 1969 return were paid or accrued in the following calendar years:

Paid or accrued in 1968	$ 792.80
Paid or accrued in 1969	226.73
	$1,019.53

4. The legal and accounting fees and title insurance expense attributable to the Worthen Building, the year such items were paid or accrued and the proper allocation of such items between the First National City Bank ("FNCB") interim loan, the New York Life Insurance Company ("NYL") permanent loan and the acquisition of the building (Sales Agreement) by plaintiff are as follows:

	1968		
	FNCB Loan	NYL Loan	Building
Shearman & Sterling, legal fees	$ 7,000.00		
House, Holmes & Jewell, legal fees		$ 8,548.34	

Rose Law Firm, legal fees	5,340.81	10,681.63	$1,780.27
Cotham, Wyman & Howland, acct. fees	1,475.00		
Little Rock Abstract Co., title ins.	5,092.50		
Beach Abstract Co., title ins.	4,927.50		
Total	$23,835.81	$19,229.97	$1,780.27

	1969 FNCB Loan	NYL Loan	Building
House, Holmes & Jewell, legal fees		$ 2,830.45	
Rose Law Firm, legal fees		4,000.00	
Cotham, Wyman & Howland, acct. fees	$ 2,000.00	1,750.00	
Little Rock Abstract Co., title ins.	120.00		
Beach Abstract Co., title ins.		3,405.50	
Total	$ 2,120.00	$11,985.95	—0—

/s/ J. G. WILLIAMSON
J. G. Williamson
720 West Third Street
Little Rock, Arkansas 72201
Attorney for Plaintiff
W. H. DILLAHUNTY
United States Attorney
By: /s/ EUGENE C. SAYRE
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IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF ARKANSAS

(Caption Omitted In Printing)

Transcript of Proceedings

(November 26, 1974)

[erroneously dated November 26, 1975]

* * *

[42]

* * *

Thereupon,

Ralph Cotham, Jr.

having been called as a witness by and on behalf of plaintiff, and having been first duly sworn, was examined and testified as follows:

The Court: Take the stand.

Mr. Giroir: Your Honor, before beginning examination, we do want to submit PX 36 as an exhibit. I have furnished Mr. Sayre a copy of it. It is a computation of the tax loss to Frank Lyon Company for the year 1969 through 2044 in respect [43] to the Northern Bank Building.

The Court: Now this is an exhibit that has not been received?

Mr. Giroir: That's correct.

The Court: Have you showed it to Mr. Sayre?

Mr. Sayre: Yes, Your Honor, I have just received it and at this time I have no objection to its introduction.

The Court: Very well.

Mr. Sayre: I believe it is what it purports to be, that being a computation of a 75 year—

The Court: It is received.

Mr. Sayre: Based upon the fact no options are exercised; is that correct?

Mr. Girori: That's correct.

The Court: Do you have an extra copy?

Mr. Giroir: Yes, I do.

The Court: All right.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 36 and was received in evidence.)

DIRECT EXAMINATION

By Mr. Giroir:

Q. Mr. Cotham, state your name. A. Ralph Cotham, Jr. [44] Q. What is your residence address A. 1600 North Jackson, Little Rock, Arkansas.

Q. What is your occupation? A. Currently I am employed as vice-president of finance for Frank Lyon Company.

Q. How long have you been employed by the Frank Lyon Company? A. Since 1966.

Q. What is your present office of Frank Lyon Company? A. Presently I am vice-president of finance.

Q. How long have you been vice-president of finance? A. Since the first of the year.

Q. What office did you hold prior to that time? A. Prior to that time I was secretary-treasurer.

Q. Did you hold the job of secretary-treasurer from 1966? A. No. In '66 I came as assistant secretary-treasurer and then became treasurer of the corporation and then became secretary-treasurer of the corporation, and I am still the secretary of the corporation but also vice-president of finance.

Q. You have been involved in the company's financial affairs since your first—— A. That's correct.

Q. What is your education? [45] A. I attended the Little Rock public schools, was graduated from Little Rock Central High School, enrolled at the College of Arts and Sciences at Vanderbilt University, was graduated there with a B.A. degree and enrolled in the school of law and received an L.L.B. degree. I was employed first by a public accounting firm. I took some undergraduate courses at UALR and took and sat for and passed the CPA exam, and I am also a certified public accountant.

Q. Are you a licensed attorney? A. Yes, sir, I am.

Q. What associations or societies are you a member of? A. I am a member of the American Bar Association, the Arkansas Bar Association, the American Institute of Certified Public Accountants, the Arkansas Society of Certified Public Accountants. And as you pointed out, I am also licensed to practice law before the Arkansas Supreme Court as well as the Eastern District of Arkansas federal court.

Q. Mr. Cotham, would you tell us what the business of Frank Lyon Company was in 1967? A. In 1967, Frank Lyon Company was a wholesale distributor of home furnishings, primarily RCA electronic products. This included TV sets, stereos, Whirlpool products, which included refrigerators, freezers, washers, air conditioners, and a little bit of furniture. The primary thing was [46] distributing RCA and Whirlpool products.

Q. How many officers did Frank Lyon Company have at that time? A. There were four branches. One is located in Springfield, Missouri; one in Fort Smith, Arkansas; and one in Shreveport, Louisiana; and then, of course, the home office is here in Little Rock.

Q. And was the company involved in basically the same business at all these offices? A. We were not involved in furniture in Springfield or in Fort Smith. We were not involved in selling RCA products in Shreveport.

Q. But each of them were home appliances? A. All of them were home appliances, wholesale distributor.

Q. Could you have opened additional offices in that business? A. No, sir, we could not.

Q. Why not? A. Our contracts with the factory specified primary areas of the responsibility, and we are required under our contract with both RCA and Whirlpool to have offices within our primary areas of marketing responsibility.

Q. Did you think you had saturated your market responsibility area? [47] A. Yes, although we were still striving to improve our market share a little bit. We do get market penetration figures which are industry-wide, which show the total number of TV sets that are sold as an example. We know what percentage are RCA and what percentage Zenith and what percentage Sylvania, and what percentage are Panasonic and Sony, et cetera.

Q. Is the Frank Lyon Company now involved in other active businesses—that is, other than the wholesale distributorship of furniture and appliances? A. Yes. In 1968 and 1969 the Frank Lyon Company purchased controlling interest of the Coca Cola Bottling Company of Arkansas and also the Twin City Bank.

Q. Did you say those were acquired in 1968? A. '69—'68 and '69. The bang was acquired in 1968. The Coca Cola Company was acquired in '69.

Q. Now, as—

The Court: Is that Coca Cola—

The Witness: Bottling Company of Arkansas.

By Mr. Giroir:

Q. You say "the bank." Would you describe the bank in which you have an investment? A. This is the Twin City Bank of North Little Rock, Arkansas. It is currently constructing an eight-story building across the river. At the time we purchased it, it had total assets of around $15 million. Under the excellent leadership [48] of Mr. Terry Renaud, who is president and chairman of the board, it now has total assets of around $85 million.

The Court: You mean since 1968?

The Witness: Yes, sir.

By Mr. Giroir:

Q. The Coca Cola Company, would you describe its operation? A Coca Cola Bottling Company is a bottler of soft drink beverages. It buys syrup from the Coca Cola Company, as well as from the Dr. Pepper Company, mixes it under the strict guidelines so the trademark is not infringed, puts it in bottles or cans and sells it both in vending machines such as the one on the floor here, as well as the supermarkets for the ultimate resale to consumers.

Q. What is its trade area? A. Its trade area is approximately one-third of the State of Arkansas. We do not have Pine Bluff. We have Little Rock, Searcy, go all the way up to Harrison, Arkansas; Little Rock and north, excluding Fort Smith and West Memphis and Jonesboro.

Q. To disgress for a minute, when you made these acquisitions, did you buy stock in each instance? A. Yes, we did.

The Court: Are they now wholly-owned subsidiaries or partially?

[49] The Witness: Your Honor, the Coca Cola Bottling Company of Arkansas is a wholly-owned subsidiary. Twin City Bank, 92 percent of the stock is owned. The other shares are owned by either officers or directors of Twin City Bank.

By Mr. Giroir:

Q. Basically qualifying shares? A. With the exception of Mr. T. E. Renaud's share ownership which is five percent of the outstanding.

Q. Your purchase of the stock of Twin City Bank, was that paid for in cash? A. Yes, it was. However, we borrowed funds from Republic National Bank.

Q. Your purchase of the stock of Coca Cola Bottling Company, was that paid for in cash? A. No, Mr. Giroir, it was not. It was the desire of the selling stockholders to maximize really their tax benefit and they required a down payment of 29 percent in cash and wanted corporate notes for a four-year period in annual payments of principal. So we paid 29 percent of it down.

Q. Roughly, how much did that 29 percent amount to? A. It was over a million dollars.

Q. And then the balance? A. And then the balance was paid for in four annual equal installments on August the 21st of each year, and that would be '70, '71, '72 and '73. [50] Q. When, as an officer of Frank Lyon Company, did you first learn of the company's interest in purchasing the Worthen Building? A. Mr. Lyons, the chairman of the board, asked me to stay a few minutes after our October 1967 board meeting and asked me what I thought of perhaps the company's owning the Worthen Bank Building. Of course, I hadn't given it much thought at all. I told him I would be glad to look into it and he urged me to do so as fast as possible and asked me to get back with him the first thing the next morning and report to him on my preliminary findings.

Q. At that point, what information did you have in respect to the investment? A. Only what he had given me, which was that the building was going to cost around $7.5 million, that we should not be too concerned with the permanent financing because Worthen Bank had already made some inquiries of some potential mortgage holders; an investor acceptable to both Worthen and, in this instance, New York Life would be able to take advantage of these initial contacts.

Q. What was your report to Mr. Lyon the next morning? A. It was an oral report. I correlated it to the objective really that the board of directors had adopted and said that I thought the possibility was worth exploring, but to really give or to give a thorough analysis that we needed [51] more information.

Q. Did you get more information? A. Yes, I did.

Q. How did you get it? A. I think at that time Mr. Lyon was going to attend a meeting at Worthen Bank and I believe spoke with Mr. Penick about the possibility of Frank Lyon Companies becoming a candidate for ownership of the building, and after their discussions then Mr. Lyon asked me to call Mr. Dick Gates who was at the time—was vice-president of Worthen Bank and was responsible for coordinating and analyzing from Worthen's point of view the various proposals they had received from other potential investors. I did so and he gave me a little more detailed information.

Q. Did you consult with any advisors in connection with your ultimate report to Mr. Lyon? A. No, sir, I did not.

Q. What was your ultimate report to Mr. Lyon? A. That I thought we ought to make a bid to own the building.

Q. At that point, was your recommendation at all predicated upon the existence of permanent financing by New York Life? A. Yes, it was, and I was really surprised in talking with Mr. Dick Gates how much they were really selling an [52] economic unit or offering to investors the economic unit, and they had made several contacts and gone into a great deal of detail with the financing officers of New York Life Insurance Company concerning New York Life Insurance Company placing a mortgage on the entire building.

Q. How did the existence of this at least tentative commitment for permanent financing affect your problem or your undertaking to make a proposal on the building? A. Quite frankly, it made it a whole lot easier. When you are going to make a seven or eight million dollar investment, the first question that always comes into my mind is where are you going to get the money. In this instance, Worthen Bank had already had contact to in part satisfy this question or answer this question.

Q. How did it affect what rental you were willing to receive? A. Well, in real estate investments at this time the

minimum requirement we would have is sufficient rental income to amortize the debt service. When you know what the annual debt service is going to be that gives a floor, which in our particular instance we were somewhat reluctant to go much below that.

Q. Did the Frank Lyon Company make a proposal to Worthen Bank? A. Yes, they did, Mr. Giroir.

[53] Q. Do you have a copy of that proposal? A. I don't have it with me. It's in the stipulation of the facts.

Q. I believe that's stipulation number 11 or PX No. 11. A. PX 11.

Q. Would you read that proposal? A. This is a letter dated October 30, 1967 from Mr. Frank Lyon, Chairman of the board of Frank Lyon Company, to Mr. Ed Penick, president of Worthen Bank and Trust Company.

"Dear Ed: In our prior conversations I have stated a definite interest in Frank Lyon Company's owning the new Worthen Building. We propose to purchase the building from you for $7.5 million under a sale and leaseback arrangement and to borrow the money from New York Life Insurance Company on a note secured by a first mortgage on the building, a conditional assignment of your lease and the general credit of Frank Lyon Company.

The lease will require you to pay all expenses necessary to operate and maintain the building including all repairs, taxes and required insurance."

Q. Do you want to continue? A. "The annual rental payment will be $50,000.00 less than the amount of mortgage payments for the first ten years, will be equal to our mortgage payments for the duration of the [54] original mortgage and will be $600,000.00 per year for the remainder of the lease.

Worthen will have the option to purchase the building after 15 years for $1.7 million cash, plus the assumption of the original mortgage. Worthen will also have options to

repurchase the building after 20, 25, 30, 35 and 40 years on a basis acceptable to Worthen Bank.

This letter merely outlines our proposal. We are flexible and want to negotiate an arrangement which is fair and equitable to both parties. Sincerely, Frank Lyon Company, Frank Lyon, chairman of the board."

Q. Did you consider this to be a definitive offer to purchase the building? A. It certainly contained most of the essential terms that we thought Worthen was looking to. Honestly, we were trying to get our foot in the door. It was quite obvious from what Mr. Dick Gates told me that other investors had made firm proposals and were under consideration, and that Worthen Bank was going to make a decision immediately. So we were, as I said, really trying to get our feet in the door.

Q. What was the response from Worthen Bank to your proposal? A. They came back and said they were—liked the terms, but there were other investors that had also submitted very attractive bids to them and they suggested that perhaps [55] Frank Lyon Company and Stephens, Inc. form a partnership to own the building jointly.

Q. What was your response to that? A. We didn't think much of that idea.

Q. Why not? A. Well, several reasons. We did not want to split any of the benefits of ownership with a third party. We knew there was going to be some hard negotiations between ourselves and Worthen Bank to kind of put the meat on this skeleton. We thought we could do it better with ourselves and Worthen Bank instead of trying to involve a third party in it. We had no prior experience of any business dealings or partnership arrangements with Stephens and this would be kind of new waters for us to tread into.

Q. So did I understand that you declined to enter into a joint venture? A. Very violently, yes. We declined.

Q. What was Worthen response to your declining to joint venture the ownership? A. Either one or two days thereafter, they contacted us again and said that rather than the

joint ownership they would like to submit to the narrow field of bidders on the building specifications for a sale and leaseback. This was a two-page typed document. They gave it to us and asked for an immediate response as to whether or not these terms would be [56] acceptable or if we wanted to modify them in any way to be sure to specify what that would be.

Q. Is that specification the document that appears as PX No. 13? A. Yes, it is, Mr. Giroir.

Q. Without going into great detail, in what material respects did the specifications deviate from your original proposal? A. Well, the big deviation came in the option price after 15 years. We had proposed to sell them the building for $1.7 million plus assuming the unpaid balance of the mortgage. In paragraph five they trimmed that back substantially.

We had also proposed rentals.

Q. When you say "substantially"—— A. They trimmed it back to only a million dollars including—to a million dollars.

Q. That was a $700,000 reduction. A. They almost cut it in half.

Q. In what other respects did the specification deviate from your proposal? A. We had proposed net rental income to Frank Lyon Company of $600,000.00. They trimmed this by $400,000.00 during the first initial five year term, made it only $200,000.00 and then cut it $50,000.00 for each five succeeding years.

[57] Are you speaking now of the renewal period following the 25 years? A. That's correct.

Q. So they reduced your net rental income during the renewal period by approximately two-thirds? A. Yes. From $600,000.00 to $200,000.00.

Q. At this point did you have any knowledge of what other investors were proposing to Worthen? A. None whatsoever. Mr. Dick Gates was very, very careful not to disclose any of the terms which any of the—information that any

of the other potential investors had given to him, and he assured me our conversations would be held confidential and he would not share the information which I had passed on to him with any of the other investors.

Q. Obviously, as we will find out later, you accepted these specifications with some modification. Why did you accede to the reduction in the option price? A. Well, in looking at the economic realities, we were very unsure of Worthen's ability to exercise at that particular time so, therefore, we discounted that factor a bit.

Q. Did you consider the option prices proposed in the specifications to relate roughly to what the fair market value of the building would be on the date of exercise? A. Yes, we did.

Q. As to the renewal, the reduction in your proposal [58] for rental during the renewal period, why did you accede to that reduction? A. Well, we wanted very much to own the Worthen Bank Building and it was obvious after having received the specifications for sale and leaseback that it was not prepared only for Frank Lyon Company and, in fact, we knew there were other interested investors. We would like to have gotten our $600,000.00, but it didn't look like we were going to be able to negotiate that and accepted a smaller return than we would have otherwise liked.

Q. Did you consider the rental during the renewal period to be fair and equitable in relation to the value of the building at that point? A. Yes, we did.

Q. Ultimately, did you respond to the specifications submitted by Worthen Bank? A. We responded by letter from Mr. Frank Lyon to Mr. Ed Penick.

Q. Is that the letter which appears as PX No. 14? A. Yes, it is.

Q. Would you read that, please? A. Yes. This is a letter dated November 1, 1967 from Frank Lyon to Mr. Ed Penick, president, Worthen Bank and Trust Company.

"Dear Ed: We have reviewed your proposal submitted [59] to us yesterday. Unequivocally we would like to accept

it. However, we do not feel that this proposal is best for Worthen Bank. Therefore, we accept your proposal with one major change. Your lease payments for the first five years will be reduced by $21,000.00 annually. On the enclosed sheet we have listed the points contained in your specifications for an easy comparison of our amended proposal with your proposal.

Ed, as you already know, we want very much to be of service to Worthen Bank. Yours truly, Frank Lyon Company, Frank Lyon, chairman of the board."

Q. And what was Worthen's response to that letter? A. They notified us that they had accepted this second proposal.

Q. Now in the specification that was submitted by Worthen, it reflected that interim financing would be made available by First National City Bank? A. That is correct. The specific sentence contained in Plaintiff's Exhibit 13 states: "Interim financing during construction is to be supplied by the First National City Bank of New York at the prime rate of interest."

Q. Were you then, after your proposal was accepted, furnished any type of commitment letter from First National City Bank in respect to interim financing? A. Well, we knew the initial contact had been made. We went ahead and submitted five year financial statements to [60] First National City Bank. We gave them a brief resume on the history of Frank Lyon Company as well as personal resumes on both Frank Lyon and C. W. Abrams, who at that time was and still is president of the corporation.

Q. Did you receive any communications from First National City? A. We were notified that we—that they would be glad to loan Frank Lyon Company the interim financing due to our ownership of the building.

Q. Did you also receive a commitment letter from New York Life Insurance Company? A. Yes, we did. We had to furnish New York Life Insurance Company basically the same information: namely, five-year audited financial statements, a brief statement of history of the company as well

as personal resumes on the chief officers. And on December 18th, they did write a commitment letter to Frank Lyon Company whereby they offered to loan Frank Lyon Company under certain terms and conditions $7,140,000.00. I think that's Plaintiff's Exhibit 17.

Q. Plaintiff's Exhibit No. 17.

THE COURT: First National City Bank is Exhibit 16?

MR. SAYRE: That is correct, Your Honor. Plaintiff's Exhibit No. 16 is City Bank's commitment.

By Mr. Giroir:

Q. After you received these commitment letters, were [61] there negotiations between Frank Lyon on the one hand, Worthen on the other hand as to the terms of the lease? A. Indeed there were.

Q. Who represented Worthen Bank in those negotiations? A. Dick Gates was the officer which represented Worthen. They were represented by Mr. Dick Williams of Wright, Lindsey and Jennings law firm. He is their legal counsel.

Q. Were there also negotiations between Frank Lyon Company and First National City Bank? A. Yes, there were.

Q. Who represented First National City Bank? A. Mr. Bob Milod, assistant vice-president of First National City Bank. His legal counsel was Mr. John Durkee of Sherman and Sterling, a law firm in New York City.

Q. Were there also negotiations and discussions between Frank Lyon Company and New York Life Insurance Company? A. Yes, they were.

Q. Who represented New York Life Insurance Company in those negotiations? A. New York Life's house counsel or general counsel, Mr. Charles Smith of New York City was the officer for the New York Life Insurance Company. Their local counsel was Mr. Darrell Dover, a partner in House, Holmes and Jewell of this city.

[62] Q. Over what period of time did the various negotiations between the four parties transpire? A. Really from

November or December of 1967 through the first part of May, 1968.

Q. What took so long? A. It's a very complicated transaction and a lot of details to be worked out.

Q. Approximately how many agreements were entered into between the various parties? A. Fifteen or twenty.

Q. In the negotiations, with whom was First National City Bank negotiating in respect to the payment of its note? A. Frank Lyon Company.

Q. And with whom was New York Life negotiating in respect to the payment of its note? A. Frank Lyon Company.

Q. Did Worthen Bank representatives sit in on any of these negotiations? A. Sometimes they did, but only when it concerned additional security that the lenders were requesting.

Q. In respect to the lease between Worthen Bank and Frank Lyon Company, did First National City Bank or New York Life have any interest in the terms of that lease? A. New York Life did because, as the commitment letter points out, one of the securities they wanted from Frank Lyon [63] Company was a conditional assignment of that lease. So, of course, they had an interest in what the lease said.

Q. Over this approximately six months period, there were obviously many negotiating sessions. Where did those occur? A. Most of them took place in Little Rock, Arkansas. Quite a few of them, however, did take place in New York City. I recall either three or four times when I personally went to New York to either meet with representatives of First National City Bank or New York Life to discuss material terms in these documents.

Q. Did the representatives of New York Life or City Bank attend any of the negotiating sessions in Little Rock? A. They attended one or two, but in the main, the negotiations which were held in Little Rock were participated in by the parties who reside in Little Rock.

Q. Inasmuch as you were depending upon receipt of permanent financing from New York Life Insurance Company, whose form or whose format dictated the structure of the transaction? A. The format of New York Life Insurance Company.

Q. Let us turn for the moment to the various agreements that were signed. As between Worthen Bank and Frank Lyon Company, what agreements were executed? [64] A. I believe there were three agreements. There was a ground lease whereby we leased from Worthen Bank ground which they owned, about a half city block on Capitol between Louisiana and Center Streets, a building lease—the ground lease, by the way, is a term of 75 years—a building lease with a term of 65 years for the tower and the other extensions of the building, the lobby and the four or five floors over that. That has got four purchase options in it. It also has options to renew the lease for rental so Worthen can, at their option, extend the terms to 65 years if they wish.

Q. Was there any other agreement between Worthen Bank and Frank Lyon? A. Yes, there was a sales agreement in which we agreed to buy from them and they agreed to sell to us the Worthen Bank Building.

Q. Turning first to the sales agreement, what was the purchase price specified in the sales agreement? A. Seven million, six hundred forty thousand dollars.

Q. How was that figure determined? A. It was outlined really in the specifications for sale and leaseback.

Q. Did it have any bearing or relationship to the anticipated cost of the building? A. Certainly it did because in all of my conversations with Mr. Dick Gates he used the figure of around $7.5 million [65] or between seven million or maybe a little more as far as the total cost of the building. That's what they thought it was going to cost.

Q. When you say "they thought," did they have a construction contract? A. I later learned they did have a construction contract at a cost plus basis.

Q. With no maximum figure? A. That was my understanding.

Q. Had that contract already been entered into at the time that you entered into the sales agreement? A. Yes, it had.

Q. Then in the sales agreement, did you buy the building as is: at that stage of completion and complete it yourself? A. No. It was very important from Worthen's standpoint they maintain a direct relationship with the contractor and the architect and the other consultants they had in the building. It was going to be called the Worthen Building and, quite rightly so, they took a great deal of pride in it and did not want to go through an intermediary in dealing with these parties they had already contracted with.

Q. Did you buy it as it was constructed? A. Yes, we did. Title passed to Frank Lyon Company as they were put in place in the building. I later learned [66] there was another reason. Dick Williams or Dick Gates told me in the meeting at that particular time under Arkansas law state banks were exempt from the sales and use tax provisions of the state revenue code. As long as Worthen was buying it and putting it in the building, they did not have to pay any use tax or sales tax on the materials.

Q. Did you review the plans and specifications which illustrated or showed what the building would be when you bought it? A. I can't really read a blueprint, and we had nice architectural renderings which we saw. Honestly, we didn't really care what the building looked like. We knew it would be a nice building, that it was the desire of Worthen to make it the most impressive office building in the State of Arkansas, and had a great deal of confidence in their abilities and taste to work with the architects and contractors to get it to be that outstanding structure.

Q. Did you require Worthen Bank to undertake to complete its construction? A. Yes, we certainly did. We didn't want to pay for a half completed building or 90 percent completed building. We elicited from them covenants and warranties that the building would be completed in accordance with the plans and specifications.

Q. Was the building to be situated on land owned by [67] Worthen Bank? A. Yes, it was.

Q. You referred to ground lease. A. That's correct.

Q. What was the length of time over which that ground lease extended? A. Seventy-five years.

Q. What were the lease payments during the first 25 years? A. The sum of $50.00.

Q. What were the lease payments during succeeding years? A. They begin at a hundred thousand dollars per year for five years and then escalated by $50,000.00 until they reach two hundred fifty.

In other words, for the first five-year period it was a hundred thousand; for the next five-year period a hundred fifty thousand dollars per year; then two hundred thousand per year for the next five years; then two hundred fifty thousand per year for the next five years. And it remained at $250,000.00 for 20 years, and for the last ten-year period it was ten thousand per year.

Q. Why was the ground rental during the first 25 years only $50.00? A. Well, we were really viewing this in relationship with the building lease and talking about the net economic [68] impact. We could have made it any figure we wanted to and we would have passed it on to Worthen in the building lease. It seemed a lot simpler to do it this way.

Q. Do I understand in the building lease you, in effect, subleased the ground back to Worthen Bank? A. That's correct.

Q. Did you specify a charge in the building lease for that sublease of the ground? A. No.

Q. If you had had a material lease provision or lease payment under the ground lease, would you have increased the building lease by roughly the same amount? A. We certainly would have. If the ground lease had been leased to us at, say, $50,000.00 a year, we would have increased the rentals on the Worthen Bank Building by 50,000 a year.

Q. During the first 25 years of the building lease, approximately what was the annual rental? A. It was approximately $580,000.00 annually for the first ten or eleven years, and then it went to approximately 600,000 for the next—

up to the 25th year. At that time it dropped to 300,000.

Q. How did the five hundred eighty and six hundred twenty figure relate to the payment that you were required to pay New York Life? [69] A. They coincide identically with them.

Q. That is during the first 25 years? A. During the first 25 years.

Q. During the renewal period, how does the $300,000.00 annual rental relate to the amount you would owe New York Life? A. We wouldn't have owed New York Life anything after 25 years.

Q. Do I understand during renewal period the rental income would be net to Frank Lyon Company? A. Absolutely. It is cash in our pocket.

Q. I'd like to focus for a minute on the relationship between the ground lease during the 25th to the 75th year as opposed to the building lease if you assume that Worthen elected to exercise its renewal. I understand that the building lease continued for 40 years at a constant rate of $300,000.00. Is that correct? A. The rental terms, yes.

Q. The ground lease escalated from a hundred thousand to $250,000.00. A. True.

Q. From the 25th to the 65th year. A. That's correct.

Q. What net effect or net rental, therefore, was Frank Lyon to get during the renewal period? [70] A. We would have received a net rental income of $200,000.00 during the first five years; a hundred fifty during the second five year period; a hundred thousand during the third; 50,000 during a 25 year period, and then the building lease terminated.

Q. The net rental in the aggregate, therefore, during the five years, 25 to 30, would be approximately a million dollars? A. That's correct.

Q. In the second year it would be in the aggregate of approximately $750,000.00? A. That's exactly correct.

Q. And so forth down to the last period.

Now at the end of the 65th year, Worthen had no option to renew its lease; is that correct? A. That is correct.

Q. At that time Frank Lyon Company had a continuation of the written ground lease for a period of ten years. A. For a period of ten years at an annual rental of $10,000.00

Q. And that $10,000.00 during the year 65 to 75 compares to $250,000.00 ground rental during the year 60 to 65; is that correct? A. That's correct.

Q. Why the drastic reduction from the year 65 to 75 in the ground rental? [71] A. We were very, very concerned about what would happen to our building at the end of the 65 year period and wanted to as a possibility of really maximizing our return on this real estate investment, negotiate with someone, hopefully with Worthen to lease the building over a ten year period at fair market values, whatever they happened to be at that time.

Q. So that if Worthen continued its building lease at 300,000 a year that would be, in effect, 290,000 per year net to you during that ten year period? A. That's correct. A total of $2.9 million.

Q. Was the arrangement as to the 65th to the 75th year specified in Worthen's specification for bids? A. It was not listed in there, no. This is one of the many points we negotiated during this six month period between the time that we first started negotiating and the time that all the documents were signed.

Q. And in those negotiations, would you paraphrase what your negotiating position or request was? A. Well, it was—since it was our building, we wanted to go ahead and were very concerned really about what position we would be in as the owners of the building at the end of the 65 year period. We felt like it would be to our advantage to go ahead and have a fixed ground rental of 10,000 a year during that time which would give us an additional ten year period to either negotiate additional rentals from Worthen—[72] as you point out, even if you keep it the same, the $300,000.00 level over that ten year period of time, that's net income to the company of $2.9 million. This was really an economic advantage that we negotiated during the six month period.

Q. If Worthen had these options at the end of 11 years 15 years, 20 and 25 years, to buy the building, why were you concerned in what was going to occur in the 65 and 75th year? A. The option only ran one way. That was their choice. I had no idea as to whether they could or want to exercise. I did know at that time they could not have exercised or could not have owned the building.

Q. After the 75th year you no longer had an option or have no option to renew the ground lease. A. That's correct.

Q. What occurs in respect to the building at that point? A. I was also very concerned about this so received an opinion from Mr. Bill Nash of the Rose law firm as to the ownership. He told me that the building still is the property of the Frank Lyon Company.

Q. So you would still be entitled to receive rental income or to sell or otherwise deal with the building after the expiration of 75 years? A. That is absolutely correct. The building does not [73] revert to the land owner unless the lease so specifies and this does not.

Q. In view of the options, why were you concerned with what would happen at the end of 75 years? A. At the time the documents were being negotiated, Worthen Bank could not own the building. I knew of no reason why they would be able to own the building. And, secondly, if they could, it would only cut one way.

Mr. Sayre: I object to that line of testimony. He hasn't shown any particular knowledge as to what the workings of the Worthen Bank and their reasons and their abilities. I think it would be proper to elicit it from a representative of Worthen Bank and not Frank Lyon Company.

The Court: Well, the agents of the Frank Lyon Company had certain attitudes of Worthen's ability which bear upon the intention of the parties, and the objection will be overruled, whether they were correct or not.

By Mr. Giroir:

Q. Turning to the financing documents—

The Court: Just a moment. You say at the end of the 75 years, the lease—you would still own the building?

The Witness: This was the legal opinion we received from the Rose law firm. Yes, Your Honor.

By Mr. Giroir:

Q. Turning to the financing documents as between Frank [74] Lyon Company and New York Life Insurance Company, what agreement did you enter into? A. We entered into a note purchase agreement.

Q. What other agreements? A. We, of course, executed a $7,140,000.00 promissory note.

Q. What other agreement? Was there an assignment of a lease? A. There was an assignment of a lease, a conditional assignment of the lease to New York Life Insurance Company.

Q. Let me ask you: The agreement we have mentioned a minute ago: the sales agreement, the ground lease, building lease, and the agreements you are talking about now: the note purchase agreement, the notes and the assignment of lease and the other agreements we will refer to in a minute, were these all executed simultaneously? A. The—most of them were. I don't believe all of them were executed simultaneously. They are dated, however. You are referring also to which specific agreement? A. To each of the agreements.

Q. I'm not sure what the date of the sales agreement is. I could check it.

Q. In point of time, were they roughly signed at the same time? A. Yes. They were negotiated during this six month [75] period, and at the end they were all finalized and executed by the parties to those particular agreements.

Q. In respect to the note purchase agreement between New York Life on the one hand and Frank Lyon on the

other hand, what was the import or the thrust of that agreement? A. Well, the note purchase agreement was New York Life's agreement to lend to Frank Lyon Company $7,140,000.00 subject to certain terms and conditions. We had to go ahead and sign a $7,140,000.00 note. We had to assign to them a building lease which, in fact, met their approval. We also warranted our five year audited statements which we previously furnished them. And we were also required to furnish throughout the term of the note audited financial statements on Frank Lyon Company.

Q. Was Worthen Bank a party to the note purchase agreement? A. No, sir, they were not.

Q. Was Worthen Bank a party to your promissory note to New York Life? A. They certainly were not.

Q. Did they guarantee that note? A. No. In no way did they guarantee the payment of that note.

Q. Is it your understanding that in the event of your default on that note that Worthen would be required to pay the [76] note? A. That is not my understanding.

Q. Does the note contain provisions for acceleration of your obligation in the event of your default? A. In the event of our default it does.

Q. Would those accelerated provisions accelerate Worthen's obligations under the lease agreement? A. No.

Q. Did Worthen Bank enter into any agreement to induce New York Life to enter into the sales agreement with you? A. Not in the sales agreement, no. Into the note purchase agreement I believe they did execute a consent and agreement, yes.

Q. In that consent and agreement, what did they consent and agree to? A. They consented to the assignment of the lease. They also consented to go ahead and subordinate their interest in the parking deck and their interest in the ground to the deed of trust, which we would execute with New York Life.

Q. Did they also agree to cause the building to be constructed in accordance with plans and specifications? A. Yes, they did.

Q. As to the interim financing, what agreements did Frank Lyon enter into the First National City Bank? A. We signed a $7 million promissory note.

[77] Q. Was there any other agreement or undertaking between First National City Bank and Frank Lyon Company? A. Yes, there was a building loan mortgage in which we mortgaged our building to First National City Bank. There was also a building loan mortgage agreement which contained some other covenants and warranties of Frank Lyon Company. Then there was a guaranty of construction and completion which Worthen Bank signed in favor of First National City Bank, in which they affirmatively covenanted to cause the building to be constructed.

Q. Just as a point of curiosity, the purchase price under the sales agreement for the building was $7,640,000.00. A. That's correct.

Q. The permanent loan was $7,140,000.00. A. That's correct.

Q. And yet the interim loan was only $7 million. A. That's correct.

Q. Why the discrepancy between the interim loan and the permanent loan? A. Well, at that particular time, we did have some excess funds which we did not mind inflowing in the construction of the building, so took funds from the working capital rather than increase the amount of the interim loan.

Q. So immediately prior to drawing on the permanent loan, what aggregate dollar amount of investment of your own [78] capital, of your own dollars, did you have in the building? A. We had $7,640,000.00 invested in the building. We had borrowed from First National City Bank $7 million, so in real estate parlance our equity at that point was $640,000.00.

Q. When you drew on the permanent loan, what amount did you receive? A. Well, we borrowed as the note shows $7,140,000.00 from New York Life.

Q. And you applied how much to repay your building loan agreement to First National City? A. Seven million dollars.

Q. And what did you do with the balance? A. Put it in our bank account. Used it to pay salaries and buy more inventory.

Q. Did Worthen Bank enter into any guaranty agreement whereby it guaranteed payment of your interim construction? A. Not to my knowledge they didn't.

Q. Did they sign the note? Did they endorse it? A. They neither signed nor endorsed the note. Frank Lyon Company is the only maker in the $7 million note to First National City Bank and is the only maker in the $7,140,000.00 note in favor of New York Life.

Q. Did they undertake to do anything in the event that the permanent loan for some reason was not closed? A. I believe in the consent and agreement they covenanted [79] to sit down and work out with First National City Bank a lease acceptable to them which would then be assigned to First National City Bank.

Q. But that was only in the event the permanent loan did not—A. That's correct.

Q. Again, this was the loan—your commitment to purchase the building, was it predicated upon receipt of a permanent loan? A. No, it was not.

Q. In the building loan agreement, did you enter into any guarantee as to construction of completion to First National City Bank? A. Let me refer to the building loan agreement, if I may.

Yes, we do, and on page three of Plaintiff's Exhibit 21 we do express our covenant to cause to be erected on the land the Worthen Building in accordance with the construction contract, et cetera. Yes, we did.

Q. The options which were contained in the lease agreement between Worthen Bank as lessee and Frank Lyon as lessor matured at the eleventh, fifteenth, twentieth and twenty-fifth year.

Q. These are with the options to purchase? A. Yes. [80] Q. Were there any other options running in favor of Worthen Bank to purchase the building? A. Yes. In the event of the insolvency of Frank Lyon Company, they had the option to go ahead and purchase the building at the appraised value.

Q. At what price? A. At the appraised value.

Q. Do you recall why that provision was included in the sales agreement? A. Well, Worthen did want the right if Frank Lyon Company went into default to be able to buy the building and perhaps resell it to another investor that was not insolvent.

Q. But it would have that right during the first 25 years at five year intervals? A. No. There were only four specific dates at which they would have it, and if we went insolvent on any other date those particular option periods would not help them any.

Q. And the purchase price under that option was what? A. Appraised value.

Q. How was that to be determined? A. By getting two appraisers and taking the price and dividing it by two.

Q. We are now to the point where you have entered into all the agreements with Worthen to buy the building, with [81] lenders to lend you the funds. Mechanically how did you obtain funds from First National City during construction?

The Court: Let me interrupt there since we are turning now and I note the time. I suggest we may want to recess for lunch. Let me ask a few questions.

I am not sure I understand the situation about building the building and Worthen had a contract directly with—

The Witness: With Matson Bellow, a joint venture.

The Court: And it was a cost plus contract?

The Witness: That's correct.

The Court: And they had an obligation under these documents to complete it in accordance with the plans and specifications?

The Witness: Yes.

The Court: Did it have any—would it have had any effect upon the transaction had the cost gone to nine million?

The Witness: Well, Worthen Bank would have still been obligated to go ahead and complete the building at whatever cost. If it cost them nine million they would have had to have completed building.

The Court: And it would not affect the agreement here?

The Witness: That's right. We still bought the building for $7,640,000.00.

[82] The Court: What, if you know, was the reason for the apparent altruism expressed in the November 1 letter about, in effect, reducing what you were regarding unilaterally: the $21,000.00? You are saying this whole agreement is not really the best for Worthen and "we accept your proposal with one major change. Your lease payment for the first five years will be reduced by $21,000.00 annually."

The Witness: We knew there were other very, very interested investors and we were most anxious to own the building. They had asked us when they gave us the specifications for the sale and leaseback to respond in that general format or if there were any modifications to let them know on the letter form. We were thinking that another bidder might just say, "Yes, I will take the building under the terms and conditions outlined in the specifications for sale and leaseback." We wanted to underbid them.

The Court: In other words, you wanted to accept it plus?

The Witness: That's correct. And we just didn't——

The Court: What thought, if any, if you recall, went into the decision to offer to reduce it by $21,000.00 as opposed to some other figure?

The Witness: We were kicking around the idea of reducing it by about a hundred thousand and we thought maybe someone else did that, so we just bettered them $5,000.00, making [83] it $21,000.00 for five years or a hundred five thousand.

The Court: I see.

Just one other question before we recess. The financing on the Twin City came from what bank?

The Witness: Republic National Bank of Dallas, Texas.

The Court: All right. How are we going? Are we losing ground?

Mr. Williamson: I think we are going a little slowly because of the length of time in the opening statements and, consequently, to be sure to get through in two days I suggest you be a little light on the lunch hour.

The Court: Why don't we be in recess for one hour. Court will be in recess. We are going to have to make it until 1:15 because I have an appointment at 1:00.

Court will be in recess until 1:15.

(Whereupon, at 12:00 noon, the above-entitled proceedings were in recess, to reconvene at 1:15 p.m., the afternoon of the same day.)

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[84] By Mr. Giroir:

Q. Ralph, when we terminated a minute ago we were discussing the sales contract and the fact that you bought a building that was under construction—that is, that Worthen Bank had under construction on a cost plus contract. A. Correct.

Q. Now I asked you earlier how you arrived at the $7,640,000 purchase price. Would you state your answer to that again? A. That was the best estimate at the time of the actual cost to complete the building.

Q. When you say "the building," what do you refer to? A. The part of the building that you typically think of as being a building, excluding the specialized leasehold improvements such as the way one tenant or law firm may want a [85] library done or the way certain tenants want certain paneling in the offices and excluding the specialized banking fixtures: vault doors and other things that a bank would want to put into any facility that it occupied.

Q. Did you have any information as to whether Worthen had gotten estimates on what the cost of the building would be? A. This was only through oral conversations with them, and it was their consensus of thinking it would be $7,640,000.

Q. When you agreed to pay $7,640,000, did you do so with the realization that they may make a profit on you? A. Yes. But we felt like that would be a fair purchase price to pay for that office building and that location.

Q. Did you anticipate that Worthen would have to expend a substantial amount of its funds for leasehold improvements? A. Yes, for the peculiar purposes of any bank they do require specialized teller equipment and vault doors and safety deposit boxes that we really were not interested in owning or do not want to purchase. It was understood by both parties that Worthen would go ahead and purchase these and make minor improvements to the building to make it suitable for Worthen's peculiar purpose as a banking institution.

Q. The type of things that you would classify as leasehold improvements for these purposes, would it include the paneling on the walls? A. Yes.

[86] Did it include interior partitions? A. Yes.

Q. What other types of items? A. Carpeting on the floor. I have already mentioned specialized banking equipment. Certainly heavy vault doors.

Q. What about consulting or other types of fees paid? A. Well, certainly anything that had to do with the interior design of the building as far as where you wanted to use oak paneling or a darker wood would really be up to the tenant. Painting on the walls, whether it was going to be white or a bright color.

Q. Did you care what the structural portion of the building looked like? A. As far as the architectural design, no. We did care that it was an attractive building and had the utmost confidence or realized that Worthen wanted it to be an attractive building and had confidence in the architects and had seen architectural renderings of the design of the building. We were not interested in paying $7,640,000 for a run-down or unattractive piece of real estate.

We did care if it was an attractive building and in that sense cared what it looked like. The fact that it might have been colored white instead of maybe some aesthetically pleasing design of black and white or bronze glass didn't concern us that much.

[87] Q. Turning again to the mechanics by which funds were disbursed to you from First National City Bank to fund the construction of the project, how were funds delivered to you? A. Frank Lyon Company opened up a regular demand deposit account at First National City Bank. I think the initial deposit was something like a hundred dollars. After we submitted our written request to First National City Bank, they would credit our account in their financial institution with the amount of our requested draw on the loan.

At that time, after we received notification of this, I would go ahead and write a regular company check and deposit it in another account of Worthen's which was at Twin City Bank.

Q. An account of Worthen's? A. Either at Worthen or at Twin City. We had two accounts. This particular account was at Twin City Bank.

And we would then deposit a check drawn on Frank Lyon Company's account with First National City Bank on our account at Twin City Bank and would transfer the funds down to North Little Rock in that manner and then would go ahead, as required, and make disbursements or reimbursements to Worthen, provided they had satisfied the requirements.

Q. What requirement did you impose upon Worthen to justify or to obtain a draw? A. It was laid out in the sales agreement. We required four things: we required either an architect or consultant's [88] certification that the amount of the materials had really been, in fact, put in place in the building and had been expanded; we required an independent C.P.A. firm's opinion as to the result of their audit of these particular bills and disbursements to show they had actually been paid and were, in fact, stated correctly; we required schedules showing what portions of the building had been completed so we'd have more detailed access to the information as to what went into the building; lastly, we required an affidavit from an officer of Worthen Bank who was the overseer of the construction saying that he was really familiar with these transactions and made certain warranties and representations or that Worthen Bank did that the figures were correct.

Q. Of the documents that you required of Worthen, how many of those documents or what part of them were required of you by First National City? A. I think only two of the four were required of First National City.

Q. Which two were those? A. I think that was the architect's certification as to the percentage that was completed and the C.P.A.'s audit of the figures and funds actually put into the building—disbursed.

Q. Why did you require the additional documentation? A. Because we wanted to make sure that they put $7,640,000 in the building. We wanted to make sure it was [89] going in there and wanted to get these other warranties and representations affirmatively sworn to by an officer of Worthen Bank as additional protection to us.

Q. At the time the building was completed, how were the funds mechanically transferred from New York Life to you? A. New York Life gave me a check payable to Frank Lyon Company in the amount of $7,140,000.

Q. Incidentally, where was that closing? A. The closing was actually in the building—in the completed Worthen Bank building in Little Rock, Arkansas.

Q. And New York Life delivered a check to Frank Lyon Company? A. To Frank Lyon Company. I endorsed that check and deposited it in Frank Lyon Company's checking account.

Q. Then what did you do with the deposit or the funds in Frank Lyon's checking account? A. That same day I had given written instructions to an officer of Worthen to wire the funds through the Federal Reserve System to First National City Bank in payment for our interim loan.

Q. When you say "wire the funds"—— A. Wire funds. Wire $7 million.

Q. And the balance of the funds, what happened to it? A. They just stayed in the checking account.

Q. What documentation do you require of Worthen in [90] connection with your drawing down the permanent financing? A. Well, basically the same—I am sorry. That we required of Worthen?

Q. Yes. A. With regard to drawing down the permanent financing?

Q. With regard to that? A. The drawing down of the permanent financing was Frank Lyon Company's responsibility.

Q. Right. But did you obtain any assurance for your own protection from Worthen before you drew the funds down? A. Okay. We did get affidavits that the building had been completed in accordance with the plans and specifications attached and also required as-built plans and specifications.

Q. You testified that you were involved in the decision at Frank Lyon Company to make this investment.

The Court: Let me back up a moment to the mechanics. You said you took title to the building piecemeal from time to time.

The Witness: Yes, Your Honor.

The Court: What were the mechanics of that?

The Witness: Well, according to the legal instruments the title passed to Frank Lyon Company as the building—as the material was actually placed in the building.

The Court: I'm just curious as to the type of instruments. What would it be? That additional space or the [91] third floor—how did you piecemeal take title?

The Witness: There was a lot of conversation struggling with that very legal issue. You can get discussion on any legal issue when you have three or four lawyers involved, but we did spend a great deal of time discussing that and finally decided that in the context of the sales agreement that we had, in fact, purchased materials when they were actually put in place and became a part of the real estate.

The Court: All right.

By Mr. Giroir:

Q. Did we, for our own clarification, describe that as brick-by-brick? A. That was the phrase we referred to. We were buying the building brick-by-brick.

Q. Would you state the reasons why the Frank Lyon Company entered into this investment? A. For many years or for the years immediately preceding the possibility of our entering into the transaction it had been a stated goal, and perhaps the most important goal of the company, to obtain some diversification. We realized that the future of our company really hinged upon our contractual arrangements with two major suppliers: Whirlpool and RCA. These contracts could be canceled, really, on 30 days' notice almost at their whim. We felt it was very important for the continuing existence of the corporation to diversify into [92] other areas.

Q. Were you at that time enjoying good earnings? A. Yes, we were.

Q. Were there other reasons? A. Yes, there were. Also at this particular time color TV sets were really in demand and we were able to sell all of them we could get and were making quite a bit of money and did have some surplus funds to invest.

As an accountant I was also cognizant of the potential challenge down the road which the service might make as far as accumulated earnings, and it was in the best interest for the company to go ahead and invest those funds in some other investment to protect ourself against a penalty tax under 531.

Q. Were there other reasons? A. Yes. Most all of the members of the executive committee were familiar with real estate transactions and had had experiences investing in real estate. Specifically, I was secretary-treasurer of several real estate corporations which paid a management fee to Frank Lyon Company, reimbursing them for my time that I spent which had similar investments, such as the IBM building, Safeway office building, National Cash Register office building.

The Court: The executive committee of your board of directors?

The Witness: Yes ,that's correct, Your Honor. It [93] was at that time Mr. Frank Lyon, Mr. C. W. Abrams, and Mr. Nash Abrams. I believe Mr. Dick Woodmansee also at that time.

By Mr. Giroir:

Q. Were there other reasons? A. Yes. As financial officer for the company I realized it is very important to obtain good relationships with your primary bank, and Worthen was our primary bank. Personally I felt if we

could go ahead and have a long-time mutually profitable relationship between them this would, in a sense, cause them to look more favorably upon us for future needs of credit down the line should anything else come on the horizon.

Q. Any other reasons? A. Just analyzing the investment itself, it seemed to be a very profitable investment for Frank Lyon Company. While, as owner of the building, we would be able to select various methods of depreciation under the Internal Revenue Code, either straight line or one of the accelerated methods, if we elected an accelerated method this would be a tax shelter for the early years. In fact, an analysis showed we would shelter in the aggregate about $3 million of taxable income during the early years and, in effect, save for a time about a million and a half in income taxes.

Also during this time we had an investment in which we were continually building up an equity in the building, and although that was no immediate cash flow, as far as the [94] difference in the rental income we received and the amount required to service New York Life debt, at the end of the 25 years we would have owned and will own the building free and clear, a building which it cost $7,640,000.

Q. Any other reason? A. Well, yes. Continuing in the time frame, should Worthen at that time elect to exercise its option to rent the building, we would receive both pretax and after tax cash flow. Since we would have no payments to New York Life or any other lender, we would receive the rental income and our expenses directly related to that building would be the ground rent, which I discussed earlier, and this would be a net cash profit to the company.

If the building lease continued at Worthen's option to renew to the end of the 65 years, we would then be in a position of having them obligated under the ground lease for a 10 year period requiring us to pay $2,000 a year. I don't know what the fair rental value of that building

will be in 50 years at the initial time, 65 years from the date that the agreements were entered into; but even if you assume a continuation of the same building rent of $300,000, this would mean that in each year we would receive in excess of a quarter of a million dollars, specifically $290,000 for the 10 year period. That's an aggregate of $2,900,000.

Q. Any other reasons? [95] A. As I think I mentioned this morning, I was very concerned about what was going to happen after everything was said and done and somewhat hopeful I'll be alive to see it although I'll be ninety some odd years old.

We did obtain a legal opinion from Mr. Bill Nash of the Rose law firm that title would still remain in Frank Lyon Company and this would be, then, a very, very valuable asset of the company at that particular time which we could perhaps sell back to the owner of the ground or take whatever steps we wanted to do to either continue to rent it or perhaps otherwise dispose of the asset.

Q. Let me for a moment quantify the types of financial inducements you felt you had. Let me talk about them with you in terms of the pure economic rewards and rewards giving consideration to tax benefits.

It seems that the pure economic rewards you referred to are primarily the renewal of the lease which will net you how much in the aggregate, approximately? A. It will be several million dollars. About—over which period are you talking about?

Q. The full 25 to 75 years—your projections. A. May I refer to my schedule?

Q. Yes. That's PX-36, I believe. A. Were you referring to the gross rental income or the net rental income after we deducted the amount due to the [96] ground lease?

Q. The net. A. All right. The net will be a hundred thousand dollars for a five year period which would be—

I'm sorry—a hundred thousand dollars for the five year period, which would be $500,000.

Q. Let's start backwards. During the last 10 years you are going to net how much? A. If you assume that we will continue to rent the building to Worthen for $300,000, we will net $290,000 per year. For the 10 year period that's going to be $2,900,000.

Q. And then you've got what, four five-year periods? A. There's a 20-year period or 25-year period. I think it is in the ground lease referred to as four five-year periods and then an additional 20-year period.

Q. And in each of those five-year periods you will net how much? A. Well, in the——

Q. Is it 250? A. Let me refer to the ground lease, if I may, which is Plaintiff's Exhibit 18.

During the time from the 25th year to the 30th year the building lease calls for rental to be paid to Frank Lyon Company in the amount of $300,000. We have to pay $100,000 per year on the ground. That's a net of $200,000 for the five-year [97] period, which would be a million dollars in hard cash.

For the second five-year period the net is $150,000 times five is three-quarters of a million dollars or $750,000.

In the third five-year period the net is $100,000 a year —that's net income to Frank Lyon Company—times five is $500,000. And then for a 25-year period there is a net of $50,000 per year, which would be a million and a quarter.

Then for the last 10-year period we don't know what the building rental will be, but if you assume a $300,000 annual building rent, it would be $2,900,000 in the aggregate.

Q. So, roughly, $6 million? A. $6 or $7 million, yes.

Q. And does that, to you, seem like a substantial benefit? A. It certainly is to me.

Q. Now there's been much conversation this morning in opening statements about there being no inducement to make the investment other than the tax benefits during the 25-year period. Does Frank Lyon individually or the company have any history of making investments that have no benefits other than following the termination of the initial lease? A. They certainly do. There are several buildings which are owned by corporations where the sole function of the corporation is just to own those buildings. Specifically the IBM building in the Industrial District, Stover Medical Supply [98] building also located in the Industrial District, National Cash Register building located in the old Safeway Office Building downtown, a retail store which, incidentally is built on leased ground in Springfield, Missouri, which was originally leased to Gibson Products Company and now leased to Handy Dan Home Improvement Center.

All these real estate investments are held by and owned by separate real estate corporations. The stockholders receive absolutely no tax benefit from them.

In all of them the rental payments are approximately equal to, although not identically equal to, the amount required to service the debt. In those cases we either elect a straight line method of depreciation or sometimes we effect an accelerated method of depreciation and do go ahead and create net operating losses that can be carried forward in that corporation for five years.

Q. Is there any income in those corporations to offset the net operating loss? A. No. The corporations only own that particular real estate.

Q. Do the corporations have any value in the real estate other than the residual value? A. That's all they have. Rental income is approximately equal to debt service. There's a little bit left over to pay Arkansas franchise tax and a management fee that goes to Frank [99] Lyon Company for my time that I spend on them.

The whole design is that after the mortgage is paid the corporation will own free and clear the real estate.

Q. Looking only at the residual value then, are these investments any different from the Worthen Bank Building? A. None whatsoever.

Q. Turning then from the non-economic to the tax benefits, did you elect an accelerated method of depreciation? A. Yes, we did.

Q. What benefit does that result in? A. Well, in the early years allows deductions in excess of the rental income. In the later years we have excess income if you will, over and above the deduction. So what we do is save income tax in the early years and pay more income tax in the later years.

Q. Do you know at what point in time in this lease that the tax shelter becomes a negative tax shelter? A. Yes. In 1980 is the last year that we shelter any income. We only shelter about $25,000 in that year.

Q. In the period up to 1980 approximately how much income and approximately how much tax do you save in the aggregate? A. We shelter approximately $3 million dollars in income and, therefore, save a little over one and a half million dollars in income tax.

Q. During the years from 11 through 25, approximately [100] how much negative shelter do you have and approximately how much tax do you incur? A. We would be paying approximately a million and a half in taxes over the last 15 years of the lease. In 1993, for example, our tax liability would be, according to these projections, about $228,000 in that one year based on this transaction only.

Q. Would that be the highest year? A. No. In 1994 it's $232,000. About a quarter of a million dollars a year.

Q. That's the highest amount of negative tax shelter? A. Yes. Now I'm speaking of the income tax we would actually pay. The negative shelter is closer to half million dollars. My computations show that in '92 for example, we will have taxable income of $436,000; in '93 about $477,000 taxable income.

Q. That's income which you are paying taxes on for which you are not receiving cash flow? A. That's correct.

Q. In view of that, what would induce you or what did induce you to elect the accelerated method? A. It's really the economic concept of a current dollar being worth more than a future dollar. There's a real economic benefit to us in being able to shelter approximately $3 million of taxable income in these first 10 years and, in effect, save approximately one and a half million dollars of income tax. [101] Q. Did you do anything specifically with the dollars that you sheltered? A. Yes, we did. I mentioned earlier that it had been the stated objective of the corporation to go ahead and diversify. Fortunately, very shortly after this transaction was completed we learned that both the majority stockholders in Coca Cola Bottling Company and the Twin City Bank were going—wanted to sell; and really were in not for structuring our ownership of the Worthen Bank Building in this way, we would not have been able to purchase both Twin City Bank and Coca Cola. We could not have paid for them.

Q. Would you elaborate on that? Exactly how did this tax saving enable you to pay for Twin City Bank and the Coca Cola Company investment? A. Well, we were able to reduce our tax liability in 1969 by approximately $237,000. In '70 we reduced it by approximately $294,000 dollars and about $212,000 in '71.

This means that the corporation was able to retain dollar amounts of approximately a quarter of a million dollars a year that otherwise would have gone in the United States Treasury. We were able to take those dollars and pay them out to third parties: namely the ex-shareholders of Twin City Bank and Coca Cola, in order to acquire those investments.

Q. If you had not made these investments, would you have been able to accumulate cash? [102] A. Yes, we would have.

Q. Did you accumulate sufficient cash to pay the full payment for these investments? A. No, we did not. It was necessary in both instances to go ahead and obtain outside financing to pay the entire purchase price. The majority stockholders from whom we purchased the majority of shares in the Twin City Bank wanted a cash settlement. It was bought from the estate of H. L. Tupp. They just wanted cash.

We were able to go ahead, partially through our own funds and partially through negotiating a loan with Republic National Bank, acquired the funds. However, in negotiating the loan with Republic National Bank we were able to use our tax savings in subsequent years to, in effect, repay that debt and were not required to rely solely upon Twin City Bank's paying a dividend it Frank Lyon Company to enable us to service the debt. As a matter of fact Twin City Bank has never paid a cash dividend since the time Frank Lyon Company acquired the stock. They have retained all earnings for their own internal purposes.

Q. Of the initial purchase price for Twin City Bank stock, do your records reflect how much you paid cash out of the corporate funds and how much you paid out of the proceeds of the loan? A. Honestly, most of it was borrowed from Republic [103] National Bank but with the idea of keeping the tax savings on this venture to help us service the debt in future years. That was on a 10-year loan.

Q. Has it been serviced? A. Yes, it has. Never missed an interest or principal payment.

Q. With respect to the investment in the Coca Cola Company, how much of your own funds did you use in that instance? A. It was 29 percent of the purchase price. The selling stockholders were very insistent on getting that amount in cash. We, at that time, had to borrow, I think it was, a half million dollars from Worthen to make that cash payment. The selling stockholders also wanted the balance for the remaining 71 percent over a relatively

short period of time. Specifically, they wanted it over four years with interest, of course.

Q. I believe you testified this morning that the aggregate down payment for Coke stock was approximately a million dollars. A. I think that's correct.

Q. So you paid—— A. Yes.

Q. ——then, 500 out of your corporate funds, borrowed 500 from Worthen, and entered into note agreements with other stockholders obligating you to pay approximately $2,000 over what period of time? [104] A. Well, the balance was payable over a four year period. Four equal installments of principal, plus interest.

Q. Have those been paid on time? A. Yes, they have. Every one of them.

Q. Have those investments been good investments? A. They have been very good investments for us.

Q. Approximately how much per year do those investments contribute to the earnings of Frank Lyon Company? A. We account for those things by reporting our equity in earn consolidated subsidiaries. This year after taxes Coca Cola Bottling Company will earn approximately $750,000. Twin City Bank will earn after taxes approximately $700,000.

Q. Do you think the investment in those companies and the earnings they have generated justifies you in being penalized with this negative tax shelter? A. They certainly do, because there's no way we could have paid for and acquired both of those investments under the terms that we did pay for them without a tax shelter.

Q. Now when Frank Lyon Company entered into this transaction did it intend to be a mere accommodation party for Worthen Bank? A. Absolutely not.

Q. Did it intend to be a straw man? A. Absolutely not.

Q. Is Frank Lyon Company's general credit obligated on [105] the note to New York Life Insurance Company? A. It quite clearly is. I also point to the requirement in the note purchase agreement where we do warrant our finan-

cial statements for five preceding years and also are required to furnish them audited statements—they want two copies, incidentally—for every year that the note is still unpaid for the 25-year period.

Q. On those financial statements how do you reflect your ownership of the Frank Lyon Company? A. We show that as an asset, originally of $7,640,000. Since it is a depreciable asset, we reflect it at the original cost, less the accumulated depreciation. And today it's on the books for a little over $6 million.

We also carry, of course, the note payable to New York Life on our balance sheet as was the note to First National City Bank until it was paid.

Q. Does Frank Lyon Company have any agreement—written, oral, implied, or otherwise—with Worthen Bank under which Worthen Bank agrees or promises to exercise its option? A. To my knowledge they do not.

Q. Does Frank Lyon Company have any form of agreement with Worthen Bank whereby they agree to pay Frank Lyon either its $500,000 equity investment or to hold it harmless from loss on its $7,140,000 note obligation? A. To my knowledge, no, they do not. Such an agreement [106] does not exist.

Q. At the time of these agreements, was it your intention of the other parties of Frank Lyon Company to become the owner of the Worthen Building? A. We clearly intended to be the owner and are the owner of the Worthen Building.

Q. The obligation which appears on your balance sheet for $7 million approximately to New York Life now. How long will that appear on your balance sheet? A. For 25 years.

Q. Will that have any effect on your corporation operation? A. It certainly will. One factor all creditors look at is who else you owe, and the fact that we have borrowed this amount of money from New York Life Insurance Company does restrict the additional amount of money we might borrow from another financial institution.

Q. Did either New York Life Insurance Company, First National City Bank, or any other party in the transaction to your knowledge consider or treat Frank Lyon to be anything other than the owner of the building? A. No, sir, they did not.

Mr. Giroir: I have no other questions.

The Court: Are all the agreements between the plaintiff and Worthen and the banks with respect to this transaction [107] in writing and here before us?

The Witness: Yes, Your Honor, they are.

The Court: There are no other outside oral or other agreements of any kind?

The Witness: Not to my knowledge.

The Court: Any further questions?

Mr. Giroir: No.

The Court: Mr. Sayre, you may cross examine.

CROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Cotham, I have caused to be served on you a subpoena to bring with you the calculations that you prepared for Frank Lyon Company with regard to this transaction and the financial tax position it put the company in. Have you brought any of those requested documents or do you have any? A. Yes. Our entire file is sitting in the back of the courtroom on that bench in a brown envelope.

Q. Would you please produce or get the file relating to the calculations that you made?

Mr. Cotham, in going through your files have you located any original copies of calculations you made concerning the economic tax position of the company if it entered into

this arrangement with Worthen Bank? A. Mr. Sayre, after the negotiations were completed and the documents signed, I went through and did clean out the [108] files. I have, however, reconstructed the benefits that we looked at at the time, and these schedules do—Plaintiff's Exhibit 36 corresponds to my best recollection to exactly what we looked at at the same time we were looking into going into this proposition.

Q. And you were planning to use—the company was planning to use the double declining balance method of depreciation? A. Yes, we were.

Q. Was the idea to shelter income from the appliance business? A. Yes.

Q. The depreciation deduction is actually a paper transaction. There is no cash pay for that amount, is there? A. Cash is paid when you purchase the building or purchase the assets.

Q. And how much did Frank Lyon put in in all cash? A. $7,640,000.

Q. Of its own money? A. Of its own money.

Q. Without borrowing any? A. No, not without borrowing.

Q. How much did it borrow? A. From First National City Bank we borrowed $7 million. So on November 30 of '69 we had put $7,640,000 in the building. [109] We had borrowed $7 million from First National City Bank and in real estate parlance had an equity of $640,000 in the building.

Q. So in net effect Frank Lyon Company put $500,000 from its own cash from retained earnings into the Worthen Bank Building? A. No, we put $7,640,000.

Q. Of your retained earnings? Not counting borrowings. How much retained earnings did Frank Lyon Company put into the Worthen Bank arrangement? A. I'm not sure exactly how you are using "retained earnings".

Q. Wasn't there a cash expenditure from the company's retained earnings of $500,000, a borrowing from New York Life of $7,140,000 to pay the entire amount of the transaction with Worthen Bank; is that correct? A. Again, we put $7,640,000 in the bank. We did borrow from New York Life $7,140,000. In real estate parlance our equity in the building was $500,000. I don't know how you correlate the exact dollars as far as coming from retained earnings or—

Q. It cost the company in cash out of its earnings $500,000; is that correct? A. No.

Q. What did it cost from the company's earnings to [110] construct the building or pay for the building? A. I'm not sure how you get from net earnings to net assets. I'm not trying to be cute or unresponsive to your question.

Q. A specification sheet, which is Plaintiff's Exhibit 13, there is a statement that the investor is expected to put up $500,000. Is that what Frank Lyon Company put up? A. I assume you're talking about paragraph number one on Plaintiff's Exhibit 13.

Q. That's correct. A. Yes. As I testified, that was the equity.

Q. My question was: The equity came from cash or money that Frank Lyon Company already had and was not from outside borrowings that it put in; is that correct?

The Court: You really asked whether it was from retained earnings.

By Mr. Sayre:

Q. If it came from current expenditures or retained earnings. It was cash that the company had; is that correct? A. Immediately before the New York Life loan was closed, our equity was $640,000.

Q. After the New York Life loan was closed. A. We had borrowed $7,140,000 from New York Life. We had purchased the assets for $7,640,000.

Q. And that left the company putting into the venture [111] $500,000; is that correct? A. As I testified, that is our equity in the investment.

Q. Then it came either from current earnings or retained earnings; is that correct? A. On borrowings or sale of other assets or liquidation of accounts receivable.

Mr. Sayre: Would you make this as Defendant's Exhibit 18.

(The document referred to was marked for identification as Defendant's exhibit 18.)

By Mr. Sayre:

Q. I hand you what's been marked as Defendant's exhibit 18 and ask if you can identify that, please. A. Yes, I can. This is a photostatic copy of the general ledger of Frank Lyon Company at 12-31-69.

Mr. Sayre: Your Honor, I would offer into evidence Defendant's exhibit No. 18.

The Court: Any objection?

Mr. Williamson: That was Defendant's exhibit 18?

Mr. Sayre: Yes, sir.

Mr. Williamson: I thought it had been offered. No objection, Your Honor.

The Court: Defendant's exhibit 18 is received.

(The document previously marked [112] for identification as Defendant's exhibit 18 was received in evidence.)

By Mr. Sayre:

Q. And you say about the time you closed with City Bank—excuse me—closed with New York Life paid off City Bank, that was in— A. On November 30, 1969.

Q. And during August of 1969 did Frank Lyon Company borrow an amount of $500,000 from the Worthen Bank? A. Yes, on August the 21st, 1969, we did.

Q. And that is reflected on the second page of Exhibit 18 as a $500,000 credit? A. That's correct.

Q. It doesn't show any payments made on the loan in the year 1969. Were principal payments made in 1969? A. No, it was a one-year note.

Q. Was it paid at the end of the year? A. No, we asked Worthen to renew it.

Q. Have they renewed it? A. Yes, they have.

Q. And they have renewed it every year since; is that correct? A. Yes.

Q. At the request of Frank Lyon Company? A. At the request of Frank Lyon Company.

[113] Q. Now your other debts as shown on this general ledger sheet, there are payments made on a loan to First National Bank of Little Rock and to accrued life insurance. Also another loan to Worthen Bank on which there are payments of $12,500. May I ask why there's been no payments on this $500,000 loan. A. It depends entirely on the terms of the note. The note you have referred to to the First National Bank and the other note to Worthen Bank were five-year notes requiring quarterly principal reductions of, in the case of Worthen Bank $12,500 a quarter; in the case of First National, $11,875 with a balloon at the end of five years.

Q. So this was a different type of note from the normal note that you entered into? A. Different from those two preceding notes, yes.

Q. This note was made some two months before the closing—two or three months before the closing—and to date there has been no payment of principal on that $500,000? A. That's right.

Q. And the $500,000 is the amount of equity that the Frank Lyon Company had in the building—excuse me, in the Worthen Bank Building as of the date of closing? A. After the permanent loan was closed, yes.

Q. Now if you will look at Plaintiff's exhibit 13, which is the specification sheet—

The Court: Let's don't go by that. Your commitment [114] was made in October of what year?

The Witness: '67 Your Honor.

The Court: All right. Now at what time did anyone in your company to your knowledge become aware of or interested in any possibility in connection with the acquisition of the Coca Cola stock?

The Witness: It was in late July or the first of August of 1969.

The Court: '69?

The Witness: Yes, sir.

The Court: And the acquisition was actually made in '69?

The Witness: It was on August 21st, 1969.

The Court: And you borrowed from Worthen a half million dollars?

The Witness: Correct.

The Court: On a one-year note which has been renewed from time to time thereafter?

The Witness: Yes, Your Honor.

The Court: Now was there any relationship of the Coca Cola acquisition to this transaction?

The Witness: None whatsoever.

The Court: Was there ever any other agreement, hidden or otherwise, or representation by Worthen that back in October of 1967 that, "If you will do this now we are going to be very [115] lenient with you or will provide capital for your future acquisitions," or was there any such understanding at all?

The Witness: Not to my knowledge.

The Court: Let me ask you Mr. Sayre. I want to follow the testimony and be sure I am aware of the significance

of each bit of it that you bring out. What is the Government's position in connection with the half million dollar loan by Worthen which has been renewed from time to time, which apparently was used by plaintiff in connection with the acquisition of the Coca Cola stock. What relationship does that have to this transaction?

Mr. Sayre: May I ask the witness one question to clarify.

By Mr. Sayre:

Q. Has there been any other loans? I believe I asked you to bring records of all loans. Are there any other loans to Worthen outstanding during that period of time other than those shown on the exhibit? A. These were the ones outstanding at that time.

The Court: What exhibit are you referring to?

The Witness: Defendant's Exhibit 18, Your Honor.

By Mr. Sayre:

Q. And has there been any other loan from Worthen Bank that has been deferred in this manner as this $500,000 loan has? A. We have complied with all the terms of each loan. [116] The one to First National Bank and the one to Worthen were originally $500,000 loans. They were five-year loans requiring quarterly reductions of principal. That was not—this was a one-year loan.

Q. Why was this handled differently and why has no payment been made? A. Because the very heavy debt payments we had to make to the ex-stockholders of Coca Cola being paid over a four-year period. We had to pay in principal approximately $600,000 a year to them, plus interest. So we had to pay somewhere between three-quarters of a million and a million dollars to them. At that time we did not want to obligate ourselves to make any fixed reduction of that note, and in talking with the officers of Worthen we thought the best way to handle it was, "They can loan it to us for a year. We will take a

look and see what our cash position is. We may pay it in full or renew it or pay it in part."

The Court: What has been the practice? Just paid the yearly interest?

The Witness: Yes, sir.

The Court: Have the renewals been on the same interest?

The Witness: Prime has gone up since then.

The Court: Is that prime?

The Witness: I think it was a half over prime. I'm sorry, Your Honor. I'm thinking of the other half million [117] dollar note.

No, this one, I believe, because Worthen realized it might be a long-term commitment, I think the interest rate was around nine percent. I think that the prime was around six and three-quarters. So it would have been about two over prime.

By Mr. Sayre:

Q. Mr. Cotham, you said Worthen was aware this might be a long-term. You said that Coca Cola Company is netting $700,000 a year in income and your tax shelter, I believe, was substantial in these years. A Yes.

Q. But you only had to pay $600,000 in payment to the —over actually a three-year period or four-year period. A. Four equal installments of principal.

Q. Of 61 percent? A. Right, the 71 percent.

Q. So what I'm asking you is: Why was this loan handled differently if you had that kind of cash flow than any other loan from Worthen Bank? A. The earnings of the Coca Cola Company have all been retained by that corporation, and they have used those to go ahead and expand the physical plant and for purposes solely related to the Coca Cola Bottling Company.

Q. Is it a wholly-owned subsidiary? A. Wholly-owned subsidiary.

[118] Q. Does it file a consolidated return? A. No, it does not, and there has been no dividend paid. Therefore, we did not have that cash. The only cash that Frank Lyon Company had was from the earnings on the sale of the appliances. This was sheltered by our real estate investments. However, at this time we had note obligations to Worthen Bank on the half million dollar note that was negotiated, I think, in '66, '67 requiring quarterly reductions of $12,500. We had quarterly reductions to First National Bank of $11,875. We had annual installments of approximately $600,000 to the "X" stockholders of the Coca Cola Bottling Company, and we had principal payments of around $300,000 a year to Republic National Bank.

Q. Did Frank Lyon Company, during the years in which this Coca Cola debt was outstanding, have taxable income for federal tax purposes—— A. The Coca Cola Company?

Q. No, Frank Lyon—or did it operate as a loss corporation? A. For 1969 I believe we had a operating loss.

Q. What about the subsequent years? A. I'm not sure. '70 I don't believe that we did.

Q. You don't believe that you did what? A. Did have a net operating loss.

Q. And you have had taxable income since then? [119] A. Yes.

Q. But you haven't used those funds to retire a debt of the corporation? A. We have.

Q. But not this particular debt? A. That's correct, not that particular note.

Mr. Sayre: Your Honor, the purpose of pointing this out is to show the circumstances were at least in a time frame close to the time of the closing of this arrangement with the permanent financing from New York Life and that the loan has been handled in a manner different from any of the loans Frank Lyon has made from Worthen Bank.

These parties were fairly closely related in their negotiations on this building, and I believe it's pertinent to show a different kind of dealing in an amount which is perhaps coincidentally or perhaps purposely the same amount as the equity in which Frank Lyon put into the building.

The Court: I want a little better explanation. It looks as if you look upon it as some sort of a suspicious circumstances, and I want to follow the inferences that are to be derived from that.

Are you suggesting that it is evidence of a hidden agreement or an additional benefit that would accrue to the plaintiff if it entered into the bank arrangement?

Mr. Sayre: Yes, sir, I think, Your Honor, it is an [120] inference of an understanding.

The Court: If, in fact, it was so, how does that strengthen the Government's position? Isn't it one of the problems that they do not charge more in connection with their offer to act as investor in this case than perhaps others or the ones they were negotiating with?

Mr. Sayre: It would show that Worthen Bank, it is the Government's position, is the true economic owner for tax purposes of this building and that in essence they had subsidized the investment of Frank Lyon Company by lending them $500,000 which has not to date had any payment paid on it and is treated differently from any other loan Frank Lyon has now or has had with the same lending institution.

The Court: Well, you mean they had at the time they put up this money, some $500,000—you call it retained earnings.

Mr. Sayre: Frank Lyon had an equity and expenditure of $500,000.

The Court: Now the suggestion is, then, they would not have put that money in or they needed it in their own

business if they did not have some commitment from the bank to replace it, in effect, by a loan in the future.

Mr. Sayre: Your Honor, Mr. Cotham has testified the tax effects or the tax shelter was desired to shelter the income from tax—unrelated or other income of the corporation from the TV appliance sales from taxation.

[121] In this manner they could have invested their $500,000 into the Twin City Bank and put the additional $500,000 that they put into the bank into the Twin City and borrow it.

Instead of that, they chose to buy the tax benefit, that being the depreciation deduction, and then Worthen Bank has made a loan to Frank Lyon Company which is identical in amount to the amount which was handed two months—over this period of time or the net effect of $500,000 put into the building by Frank Lyon Company.

The Court: Mr. Cotham, how about the Twin City investment? Was that opportunity known to any of the officers of the plaintiff or yourself at the time that you made the commitment on this bank building?

The Witness: No, Your Honor, it was not. That only became available when the president of the Twin City Bank, Mr. H. L. Tupp, died and the heirs of his estate decided to liquidate his investment.

The Court: He died when? In '68?

The Witness: I just don't recall the date of his death, but I believe it was in the spring of '68.

The Court: And did that transaction have anything to do with this——

Mr. Sayre: Excuse me, Your Honor. I believe I said Twin City Bank and I believe we are talking about Coca Cola.

The Court: We are talking about both, I guess, if [122] you're looking at both. Mr. Cotham testified the company was doing well and looking to diversify and shows this particular opportunity to look upon it as such and as a consequence of it created the potential acquisition of still others.

But these others, at least one of them some two years later shortly before the closing of the loan, required additional money they had to borrow. If it had some relationship, if it was part of the transaction, a hidden part of it, and if that is what I should be looking for I want to and to follow your theory. But the Court just—I am like you: $500,000, suspicious circumstances. But suspicious of what, and how am I to follow it through and be sure I get your point? From time to time when you are trying it to the Court I'm going to be asking questions to find out why you are asking.

By Mr. Sayre:

Q. With regard to the interest rate, is it still carried at nine percent? A. I believe so, yes.

Q. Which is how much below the prime? A. Well, until the Brock bill was passed we had a 10 percent usury limitation and all our notes to the Arkansas banks had been 10 percent.

Q. And it is still carried below prime? A. Yes. I don't recall the exact rate; between nine and ten percent.

[123] Q. It's your testimony that to your knowledge there was no understanding of Worthen Bank that it would make a loan of $500,000 to Frank Lyon Company about the time of the closing? A. That's correct. There was no understanding.

Q. Now with regard to paragraph one of Exhibit 13 which is b under specification, "equity to be supplied by investor, $500,000, and annual rate of interest to be charged thereon, six percent." That's couched in terms of a debt. You pay interest on a debt obligation.

It's the Government's position in this case that in substance for tax purposes Frank Lyon Company made a loan to the Worthen Bank of $500,000. May I ask why or how it was calculated that six percent would be returned on that money and also how in Exhibit 14 the Frank Lyon Company acknowledged that there would be six percent on the second page? A. To answer your first question, the sale and leaseback was directed by the officers of Worthen Bank. I don't know why they phrased it that way.

In response to your second question, we quote virtually verbatim their specification for sale and leaseback they had handed us approximately two days earlier without alteration except for an offer of the $21,000 that we mentioned in paragraph two of the lessor.

Q. With regard to that $21,000 actually you said you made that as an inducement. The actual terms of the agreement [124] between Frank Lyon Company and Worthen Bank do not reflect that $21,000 saving, do they? A. That's correct, they do not.

Q. They go back to an amount in excess of $571,000—$583,000. A. What five eighty-three?

Q. Instead of $142,000, it's a little over $143,000; is that correct? A. I don't recall off-hand without referring to the note. Whatever the note says is correct.

Q. Well—— A. What exhibit is that?

Q. Look at your debt service, which is Defendant's exhibit No. 7, and it will show you the amortization schedule. I think the note is probably Exhibit No. 26 or 27. A. Right.

Yes, it does require quarterly installments of $145,581.03.

Q. So there was no saving of $21,000 by the bank by agreeing to Frank Lyon's proposal—— A. Correct.

Q. —for accepting Frank Lyon's counter proposal. A. Correct.

Q. Now you stated you made these calculations and one of the intentions was to shelter income by use of the double [125] declining balance method of depreciation. A. That's correct.

Q. Now was it also one of the considerations that at that time Section 1250 of the Internal Revenue Code provided for recapture on accelerated depreciation of buildings? If a building was held longer than 10 years there would be no recapture. A. I was aware of that provision, yes.

Q. So the first option date being 11 years would mean if the transaction stood without being questioned that capital gain would be realized on the entire amount of the exercise of the option price, if exercised? A. Correct, but the option periods were dictated by Worthen.

Q. You were aware of the fact? A. I was aware of the facts, yes.

Q. May I ask why—you said 11 years is the maximum shelter that can be achieved. A. Yes.

Q. Then it starts to go back the other way? A. Yes.

Q. May I ask why the rental payments were designed to change at 11 years and increase and did increase some $8,000? A. This was part of the package that Worthen Bank had offered to us, Plaintiff's Exhibit 13.

[126] Q. I believe these figures were not used. The other figures were used. In your note you read a moment ago, $145,000 and $153,000 were actually used. Why did Frank Lyon Company agree to the increase in rent after the end of 11 years? A. The rental income and the debt service were to be approximately equal.

Q. They weren't to be approximately equal; they were to be exactly equal; is that correct? A. They were equal.

Q. To the penny? A. To the penny—for the first 25 years.

Q. Now going back to Exhibit No. 13, Worthen Bank had contracted—had already broken ground in September of 1967 on the construction of the property; is that correct? A. Yes.

Q. And Defendant's Exhibit—I don't remember the number right off, but the contracts between the architect and the bank, between the overseeing consulting engineer and the bank, and between the construction company and the bank were all in effect prior to the time that Frank

Lyon came into this arrangement; is that correct? A. That is correct.

Q. And during the entire period of construction of the bank after Frank Lyon Company came into the picture in May of 1969, the bank continued to oversee the operation at the site [127] and the actual construction of the bank? A. That is correct.

Q. You did not assume any obligation under the contracts with these building architectural entities? A. Not with the architect nor with the contractor, that's correct.

Q. And one of the reasons was because Worthen Bank wanted to save approximately $125,000 in sales tax that it could save as the builder of the building; is that correct? A. That's what one officer told me, yes.

Q. If you, being Frank Lyon Company, had purchased the building or, in effect, you really didn't purchase a building as such; it was under construction at that time and you said you purchased a little bit as it went up; is that correct? A. That's correct.

Q. If Frank Lyon Company had built the building and leased it back, the amount of sales tax would have been added into the cost; is that correct? A. Yes.

Q. So there was a savings to Worthen Bank of $125,000 by doing it in this manner; is that right? A. That's correct.

Q. Under Exhibit 13, one of the requirements was that all investment credit and sales tax savings with regard to the construction of this building be passed through to Worthen Bank; [128] and it was, in fact, passed through? A. Yes, it was.

Q. So all investment credit on the building itself or the equipment in the building went to Worthen Bank rather than Frank Lyon Company? A. Yes.

Q. And prior to Frank Lyon Company getting into this arrangement, there had been numerous trips by Worthen Bank to New York to visit with First National City Bank and also with New York Life, and they had commitments

for interim and permanent financing before Frank Lyon Company came into the picture; is that correct? A. I have no knowledge about any trips they took. I do know they had made initial contacts.

Q. And they had commitments on the financing subject to finding an acceptable investor? A. Subject to the lendor's—yes, approving the borrower.

Q. Now this exhibit says that the interim financing is to be supplied by City National Bank of New York at prime rate, such interest to be paid by Worthen on amounts actually disbursed.

The Court: Where are you reading from?

Mr. Sayre: The next to last paragraph before the numbers, Your Honor.

The Court: In which document?

Mr. Sayre: Exhibit 13.

[129] The Court: Oh, I see.

Mr. Sayre: There's a series of numbered paragraphs, and it was the one before.

The Court: All right.

By Mr. Sayre:

Q. Now under the proposal of Worthen Bank they would pay the interim financing interest charge; is that correct? A. That's apparently what the specification of the sale and leaseback provides, yes.

Q. And did they pay the amount? A. No, sir, they did not. Frank Lyon Company paid the interest.

Q. Frank Lyon Company paid interest and fees to accountants and to attorneys of approximately $500,000 in connection with the construction of this building; is that correct? A. Yes, between $450,000 and $500,000, yes.

Q. And you cannot tell the Court why the specifications state that the investor would put in $500,000 at an annual rate of interest of six percent or why the company acknowledged that in its agreement? A. We acknowledged it because we were just trying to repeat verbatim the specifications for the sale and leaseback they handed us.

Q. On your calculations have you made calculations to show what the tax position of Frank Lyon Company would be if [130] the options were exercised? A. Yes, we did.

Q. It would be, at the end of 11 years, approximately $300,000 in gain; is that correct? A. On the sale there would be about—I think it was about three and a half million dollar gain on the sale.

The Court: Apparently there were considerable negotiations after the specification and letter——

The Witness: Yes, Your Honor, there were.

The Court: —in which additional terms were agreed upon which were reflected by the documents; is that correct?

The Witness: That is correct.

By Mr. Sayre:

Q. Now with regard to the construction, you said the Worthen Bank oversaw the complete construction. I take it the mechanics would be that on a monthly basis demand would be made by the contractor—the general contractor to Worthen Bank for payment, and Worthen Bank would then make demand upon you to pull down amounts from City Bank under the financing agreement, and you would reimburse Worthen Bank for their payment to the contractor. A. We would not reimburse Worthen. We actually paid the contractor.

Q. In other words, Worthen paid all the bills for the construction of the bank and you drew the money from City Bank [131] and paid it to Worthen? A. Yes. We reimbursed Worthen.

Q. Frank Lyon Company did not have anyone to oversee the construction of the building? A. That's correct.

Q. Now you said that with regard to this rental, it's equal to the penny to the debt service owed to New York Life? A. That's correct.

Q. And there is, then, no hope of making a cash flow or an economic profit off this arrangement for the first 25 years; is that correct? A. From a cash standpoint for the first 25 years that's correct, outside of the income tax consideration; but from 25 to 75 there would be.

Q. But in the original 25 year term which the bank has four options to repurchase, there is no way that a cash profit or cash flow can be made by Frank Lyon Company? A. That's right. Our economic profit comes from increasing the equity in the building.

Q. Now the equity, you say, in the building—the amount of the option price of Worthen Bank in the building lease—decreases instead of increases; is that correct? A. That's correct.

Q. So that if the building increased in value or appreciated in value or stayed the same and had a market value of [132] seven and a half or $9 million, or whatever that value of the total investment in the building was, that at the end of the 25-year term any appreciation that would be in that building could be taken away from Frank Lyon Company by the Worthen Bank's exercise of the option for the stated option price? A. They would purchase the building for the stated option price.

Q. And, therefore, there would be no equity or appreciated value to Frank Lyon. It would be taken away by the exercise of the option? A. We would have sold it for approximately two plus million dollars at the end of the twenty-fifth year.

Q. We are assuming that the value of the building stays between 7 and $9 million. A. I'm not sure that's a valid assumption. Buildings would deteriorate.

Q. Then it's your assumption that the market value of the building would be only $2 million in 19—or after 25 years? A. Perhaps, yes.

Q. Now with regard to the term of the rental under the building lease, Frank Lyon Company at the end of 25 years

would be receiving in excess of $600,000 a year; is that correct? A. At the end of which period, sir?

Q. At the end of 25 years. A. At the end of 25 years?

[133] Q. You were going into what you were going to get after 25 years, and that's all assuming that no option is exercised by the bank. A. That's correct. Our original proposal was we would receive $600,000 a year.

Q. What I'm asking is: Why would Frank Lyon Company be willing to cut its rent in half? If $600,000 would be the fair rental value in 1994, then the next year why would they be willing to take half and the net amount greatly reduce some over that period? A. Half a loaf is better than no loaf. It looked like other investors against whom we were competing were willing to do it for less, according to the terms of the Specification of Sale and Leaseback. So the $300,000 rent was just out of the question. We did have to settle for a smaller amount of rent.

Q. The ground lease on the building site was for $50 for the initial 25-year term? A. That's correct.

Q. And that, you explained, was because of a net effect but that was not the fair rental value of that property. A. No, it was not.

The Court: Mr. Sayre, let me interupt you to give the court reporter a break. We will be in recess for 15 minutes.

[134] The Court: Mr. Sayre, you may continue.

By Mr .Sayre:

Q. Going back again to the depreciation deduction, that is not an actual cash expenditure or cash expense. It is a bookkeeping entry; is that correct? A. The cash disbursement has been made when the asset was purchased.

Q. And that's where we came into this $500,000 versus $7,640,000.

Now Worthen Bank paid to Frank Lyon Company an amount identically equal to the debt service so that the money Frank Lyon received from Worthen Bank was then

turned over to New York Life and paid off principal and interest payment; is that correct? A. The rent check goes into our regular bank account and we do write a check in the same amount to New York Life to pay our debt.

Q. There's no yearly expenditure for depreciation. It is a bookkeeping entry theoretically to recover costs of amounts expended. A. It's a non-cash expense in that year.

Q. And the cash expenditure that Frank Lyon Company made was $500,000 in equity, and then for bookkeeping purposes or for tax purposes, or however it's accounted for on your books, amounts were received as rental, credit as rental, and [135] deduction taken; is that correct? A. Which $500,000 are you referring to?

Q. The original $500,000 in equity put into the—— A. Again, we purchased the building for $7,640,000. On that investment we are receiving rentals of around $580,000 a year.

Q. For tax benefit purposes, a cash expenditure was made from Frank Lyon Company's own funds of $500,000? A. That was our equity in the building.

Q. And an asset was acquired with a basis of $7,640,000 which was depreciated then by Frank Lyon Company? A. Yes. They are the owners of the building.

Q. And what is the depreciation deduction in the first full year of 1970? A. It's about $614,000.

Q. And the interest payment was how much? A. In the first year it was $478,000.

Q. So about a million dollars? A. Total deduction in the first year, yes.

Q. A million dollar deduction on a $500,000 cash expenditure from funds? A. Rental income of about $582,000 in that year.

Q. Excuse me. Then there was a net amount of $400,000? A. Approximately.

Q. Again you say that Frank Lyon Company bought a building. [136] The building was not completed. It was in

the process of being constructed. It had already been started by Worthen Bank. A. That's correct.

Q. And they paid for all the expenditures for the land, the parking garage, and the initial million or million and a half dollars in expenditures for the building before Frank Lyon came into the picture; is that correct? A. That's correct.

Q. So actually would you say the basement belongs to Worthen and you own the rest of it? A. No. We own the building.

Q. Now on Exhibit 13 on the options on the second page, how were the amounts determined of 822, a million, a million-six, and two million one hundred forty-five? A. I don't know. This was prepared by Worthen Bank.

Q. Eventually the amounts that were agreed upon were couched in terms not of an assumption plus this amount but an assumption—excuse me, a total dollar figure; is that correct? A. Yes, that's correct.

Q. I believe paragraph 21 or something of Exhibit 19 is the option.

Now there is a discount factor of $198,280 shown on the fifteenth year. Was that carried over into the agreement? A. I don't recall specifically, but I assume it was.

Q. What does that discount represent? [137] A. I don't know.

The Court: What are you talking about?

Mr. Sayre: The second page, Your Honor——

The Court: I have it.

Mr. Sayre: —where it shows the $1,198,280 minus $198,280.

The Court: In parenthesis.

By Mr .Sayre:

Q. What is the discount determined, and if it was carried over what does it represent? A. It looks like it was just

an amount to round the fifteenth year off to a million dollars—the figure that was backed into—but that is just a speculation on my part. As I said, I did not prepare this specification.

The Court: Do you know what the figures are in the parenthesis: the eleventh year or fifteenth year?

The Witness: No, Your Honor, I do not.

The Court: All right.

The Witness: The one for the fifteenth year apparently ties into paragraph six. The amounts are the same as "B" and "C".

By Mr .Sayre:

Q. Let me ask you. On Exhibit 14 you show a repurchase after the eleventh year. Now you prepared this exihibit? A. Exhibit 14, yes.

[138] Q. Second page. What is the discount of $149,000 there representing? A. We were again copying verbatim the form they had given us, and it's just an amount to round off—it looks like the equity to $800,000.

Q. Let's go back to—do you have the knowledge if this figure of $822,000 or approximately $800,000 as shown on your computation, Exhibit 14, was the amount of the net amount received not on the assumption but the net amount to be received under the final agreement? A. I assume it was. We could tie it out by taking a look at the amortization schedule by taking a look to see what the outstanding balance of the mortgage would be.

Q. That's Defendant's Exhibit 7. A. Yes, sir, that's approximately the figure. You're Defendant's Exhibit 7 shows that the outstanding balance of the debt is $5,521,000 at that time, and the option price in section 20.1 of the building lease is $6,325,000, approximately, so that would be $804,000 cash.

Q. That would be the amount of net equity again or net equity realized by Frank Lyon out of the transaction; is

that correct? A. That would be the cash that we would receive on the sale. They would assume the mortgage and give us that much in cash.

[139] The cash put in by Frank Lyon was originally $500,000 is that correct? A. The equity in the building, yes, was $500,000.

Q. So there would be an increase to Frank Lyon Company of a little in excess of $300,000 in cash if the option were exercised at the end of 11 years? A. Yes.

Q. Now was this calculated prior to the time the instruments were entered into? A. I'm sure it was.

Q. Does that amount represent approximately six percent interest as referred to in your Exhibit 14, which is your acceptance, and the bank's Exhibit 13, which is their specifications? A. Let's see. Purchased the building for $7,640,000 and borrowed seventeen-forty from New York Life, so our equity was a half million dollars. Three hundred forty divided by a half million is about 60 plus percent, so divided by 11—plus or minus six percent, roughly.

The Court: In other words, the least benefit that Frank Lyon could make would be, in effect, a six percent on its money, plus the tax benefit which would accrue during the period of this time?

The Witness: Yes, Your Honor, if Worthen exercised their option at that time.

[140] The Court: Under any other set of facts they would receive more benefits?

The Witness: Yes, Your Honor.

By Mr. Sayre:

Q. You said that these two entities that Frank Lyon Company invested in: Twin City Bank and the Coca Cola Company, were both money makers or profitable corporations? A. Yes. But no dividend has been paid by either one to Frank Lyon Company.

Q. But they were viable; profitable corporations that were acquired by Frank Lyon? A. Yes.

Q. At one time did Frank Lyon Company own or have a subsidiary that owned a Gibson's discount store? A. Yes.

Q. Was it a profitable venture? A. It was for awhile.

Q. And then became a loosing venture? A. Less than acceptable return.

Q. And it was disposed of? A. We sold it, yes, to the Jasper Howard Group who had a larger chain of discount stores.

Q. Now the Worthen Bank transaction was not profitable during the initial 25-year term of the lease to the Frank Lyon Company; is that correct? [141] A. No, that's a correct [sic] statement. It was profitable.

Q. During the first 25-year period? A. During the first 25 years.

Q. How was it profitable? A. Because with every principal payment on the debt service, we were reducing the amount we owed on the mortgage and thereby increasing our equity in the building.

Q. You said one of the reasons that Frank Lyon Company wanted to get this was to build up an equity in the building. Again, you admitted that if Worthen Bank exercises its option, Frank Lyon Company would lose the equity. A. We would sell it to Worthen.

Q. Under the agreement you would have to sell for the stated price. A. That's right.

Q. You have no equity. A. But we would realize a gain on the sale.

Q. Excuse me. You would realize a gain on the sale? A. Yes. I thought you just asked me to compute that it was around six percent.

Q. About six percent gain on the sale? A. That would be per year on an annualized rate. It's really about 60 percent on the equity at the end of the eleventh year.

Q. You said it would be mutually profitable to both [142] entities—both Worthen Bank and Frank Lyon—to enter

into such an arrangement is one of the reasons. Was that the fact that you were told you would get this loan of $500,000 or favorable treatment on similar loans? A. No. As I pointed out, one of the reasons I was anxious to enter into it was I hoped it would strengthen our relationship with Worthen Bank.

Q. You said it would be profitable in as much as the double declining balance depreciation deduction would give you a cash savings of about a million and a half dollars in the first 11 years. A. That's correct. It would shelter about $3 million in income and would save taxes totaling a million and a half.

Q. And all of these speculations about what would happen after 25 years and after 65 years and after 75 years would not ever come about if Worthen Bank exercises the option to purchase; is that correct—exercises the option to purchase or repurchase? A. Speculating on whether they would or would not exercise the option, it may or may not come about.

Q. We are assuming if they exercise the option all that is wiped out. A. If they don't, it's very real.

Q. You stated in the other transaction regarding subsidiary corporations, I believe, of Frank Lyon Company are real estate corporations. Are they subsidiaries of Frank Lyon? [143] A. No, they are not.

Q. Are they real estate corporations owning property or stores in which subsidiaries have their operations. A. Some of them are, yes.

Q. And there is a small cash flow on these? A. Minimal cash flow.

The Court: Let me interupt a minute. I haven't looked at the witness list. Are we going to have any experts on sale and leaseback agreements here to testify?

Mr. Williamson: Yes, Your Honor.

The Court: All right.

Mr. Sayre: Your Honor, I think I have reached a point if you would like to take Mr. Dover out of sequence at this time, it would be all right.

The Court: It is your pleasure, gentlemen. I can do it any way you wish.

Why don't you stand down, Mr. Cotham.

(Witness excused.)

The Court: Mr. Dover, come forward, raise your right hand, and be sworn.

Darrell Dover

having been called as a witness by and on behalf of Plaintiff, and having been first duly sworn, was examined and testified as follows:

Thereupon,

[144] DIRECT EXAMINATION

By Mr. Giroir:

Q. State your name for the record, please. A. Darrell Dover.

Q. What is your residence address? A. 22 River Valley.

Q. What is your occupation? A. Attorney.

Q. With whom are you associated in the practice of law? A. House, Holmes and Jewell.

Q. That's a law firm here in Little Rock, Arkansas? A. Correct, sir.

Q. Did your firm serve as counsel to New York Life Insurance Company in connection with a permanent loan to Frank Lyon Company to purchase the building? A. Yes.

Q. When were you employed? A. '67. Late '67 or early '68.

Q. Do you recall whether or not a written commitment had been issued to Frank Lyon Company by New York Life at that time? A. Yes, sir, it had been.

Q. Are you personally familiar with any of the negotiations or background leading up to the issuance of that letter? A. No, sir.

[145] Q. Who was your primary contact or whom did you associate with in New York Life Insurance? A. Mr. Smith, Charlie Smith, assistant—I believe he's assistant chief counsel for New York Life.

Q. Did you consider him to be knowledgable in real estate lending matters? A. Very.

Q. Was he active in connection with structuring of the transactions? A. Yes, sir. Yes, sir. He played a large part.

Q. In your dealings with the lendor or with the borrower, Frank Lyon Company, with whom did you have contact? A. Yourself and Mr. Cotham.

Q. In your dealings with the interim lendor, First National City Bank, with whom did you have contact? A. Mr. Dirkey with a New York law firm.

Q. With Worthen Bank with whom did you have contact? A. Mr. Dick Williams of the law firm——

The Court: Wright, Lindsey and Jennings.

The Witness: Excuse me, Your Honor.

By Mr. Giroir:

Q. Did the negotiations extend over an extensive period of time? A. Yes, sir, they did. Awhile ago I said I was employed in either late 1967 or early 1968. The negotiations continued [146] for approximately [illegible] to six months.

Q. What took so long? A. Well, there was just considerable give and take, bargaining, negotiating between parties. I assume these documents are in evidence. There were volumes of documents and they were negotiated chapter and verse, paragraph by paragraph, almost word for word.

Q. How would you characterize the negotiations between the four parties? Were they serious negotiations? A. Certainly. Certainly very serious.

Q. Were important terms of each of the documents the subject of conferences and discussions? A. Yes, sir. Yes,

sir. As I say, it was virtually a paragraph by paragraph, provision by provision negotiation.

Q. Now in some instances did all the parties participate in the negotiations? A. Yes, sir.

Q. In all instances did all parties participate in the negotiations? A. I have searched my recollection. I think there were certain instances where simply New York Life and the Lyon Company were represented. Just the two parties: lendor and borrower.

Q. Were any of those instances where New York Life Insurance Company and Frank Lyon representatives were involved [147] in the negotiating, were any of those conducted out of town? A. Yes, sir. My memory is that there was a trip to New York at which one of those conferences took place.

Q. Were there instances where negotiations were conducted only by Worthen and Lyon but perhaps in your presence? A. Conversations, yes, sir. Discussions.

Q. What was your interest in the lease agreement between Worthen and Frank Lyon? A. Well, the lease agreement is a major part of the security for the loan. As I recall the transaction, it is structured so that the lease would survive the foreclosure by New York Life and we'd be looking to Worthen Bank and Trust Company as the leasee.

Q. Was there any guarantee by Worthen Bank of Frank Lyon's note to New York Life? A. No, sir.

Q. To whom did New York Life look as the borrower and primary obligor on the note? A. The maker, Frank Lyon Company.

Q. If there was a default by Frank Lyon Company and New York Life elected to accelerate the obligation of Frank Lyon Company, did that also trigger an acceleration or otherwise disturb Worthen Bank's lease? A. No, sir. No, sir. As I say, it was structured—this is from memory but I think it's accurate—it was [148] structured so the lease would survive an acceleration or foreclosure or what have you.

Q. So in the event that Frank Lyon defaulted you could be conceivably in litigation with Frank Lyon while at the same time Worthen Bank went along unaffected. A. Correct.

Q. Conversely, if Worthen Bank defaulted on the lease, did that trigger a default on the note? A. No, sir. No, not legally. Practically it probably could have if that resulted in the Lyon Company not having the funds with which to pay New York Life.

Q. But that second step would have to occur? A. That would have to occur. Legally it was not so structured.

Q. I take it, then, your employment, at least in part, was to give New York Life the opinion that Frank Lyon had a full face and credit obligation to pay $7,140,000 to New York Life.

Mr. Sayre: Your Honor, I object to the leading nature of the question. It is assuming.

The Court: Please don't lead the witness.

By Mr. Giroir:

Q. What was the purpose of your employment? A. It was to render an approving opinion to the New York Life Insurance Company, assuring them that it had a valid [149] and enforceable obligation of the Lyon Company.

Q. Were you employed to give an opinion as to whether or not Worthen Bank had an obligation under the note? A. No, sir. I previously testified it had no such obligation.

The Court: Do you know if your client was concerned with or took an interest in the net worth of the plaintiff and its financial reliability?

The Witness: Your Honor——

The Court: That is, the Frank Lyon Company.

The Witness: I'm new to this proceeding. The plaintiff is Frank Lyon Company?

By Mr. Giroir:

Q. The plaintiff is Frank Lyon Company. A. Yes, sir. Yes, sir. We were furnished either four or five years financial statements of the Lyon Company.

Q. Insofar as you were concerned, do the documents reflect the intention of the parties? A. Yes, sir. I have our firm signatures on the opinion to that effect.

The Court: Particularly, did the documents carry out the instructions as to those intentions given to you by your client?

The Witness: Yes, Your Honor.

The Court: All right. Anything else?

[150] Mr. Giroir: No further questions.

The Court: You may cross examine.

CROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Dover, was the New York Life Insurance Company also interested in the financial wellbeing and net worth of the major tenant or the tenant of the building, the Worthen Bank. A. Surely.

Q. And, in fact, New York Life requires that a yearly financial statement be submitted by Worthen Bank to New York Life with regard to this note purchase; is that correct? A. I think that's correct.

Q. The arrangement for the financing with New York Life, the permanent financing and the construction of the Worthen Bank Building was arranged by the Worthen Bank intially? A. I have been so told.

Q. You said——

The Court: Do you know if the tentative arrangement that had been worked out between Worthen and New York Life were entirely conditional and particularly were they

conditional upon an investor who was satisfactory to your client, or do you know if that was a matter of importance or not discussed or——

The Witness: Judge, that predated my connection with the case. I feel sure that—this is sort of speculation, but I feel, yes, sir, the New York Life would have—the investor [151] would have had to be satisfactory to New York Life.

The Court: Were there any binding contractual agreements binding your client as a result of its associations with Worthen prior to the time that Frank Lyon Company entered the picture that you know of?

The Witness: No, sir. No, sir. But I have no real knowledge of that.

The Court: I'm sorry.

The Witness: I have no real knowledge of what predated my connection with the case.

The Court: I understand. Of course, you had to take it as it was given to you.

The Witness: Our firm was purely special counsel. My understanding was that it had a conditional commitment subject to satisfactory documentation, proof of title.

The Court: When you entered the picture they had already had negotiations with Frank Lyon?

The Witness: Correct, sir.

The Court: And you were more or less called upon to carry out those terms and those formally expressed items?

The Witness: Yes, sir. Yes, sir.

By Mr. Sayre:

Q. In fact, Mr. Dover, weren't you brought in as the representative to represent New York Life because prior to the time they had been represented by the Rose law firm

which was [152] representing Frank Lyon in this matter? Was New York Life a client of the Rose firm? A. Yes, sir.

Q. So to avoid a conflict of interest the House, Holmes and Jewell firm was brought in? A. As special counsel.

Q. And the firm of Wright, Lindsey and Jennings was brought in as special counsel for Worthen rather than the Rose firm that had been used by the Worthen Bank; is that correct? A. I'm so told.

Q. Now New York Life demanded or requested or wanted to acquire or achieve the purpose of having Worthen Bank pledge its assets: the land, the parking garage, as additional security on the deed of trust; is that correct? A. Yes, sir.

Q. And if there was a default you would look to take the deed of trust and turn it into or foreclose on the deed of trust; is that correct? A. That was a possibility I imagine.

Q. You were the trustee and hold this deed of trust or you are the trustee at this time? A. Yes, sir. Yes, sir.

Q. Now the steps of this transaction—by that I mean the guarantees of Worthen Bank to Frank Lyon Company and Frank Lyon Company's guarantees to New York Life in the note and the [153] deed of trust and in the building lease—are similar. In other words, the obligations of Frank Lyon Company to New York are similar to the obligations of Worthen Bank to the Frank Lyon Company; is that correct? A. Your reference to guarantees has confused me because we hold no guarantees.

Q. I refer to the terms of payment. They are identical; is that correct? The rental payments are identical to the debt service? A. Yes, sir, I believe that to be correct.

Q. And Worthen Bank has guaranteed to make the payments to Frank Lyon Company under the rental agreement or the lease. Even if the building is damaged or destroyed they have a guaranteed obligation to pay the rentals for 25 years; is that correct? A. I feel sure that's correct. That is a particular instance where there were substantial

negotiations: the damage to constructions clauses and the condemnation clauses of the various instruments. But, yes, sir, I think the answer to your questions is yes.

Q. And if the building is destroyed or damaged the option—the bank can use the proceeds to pay what is referred to as the assigned, which is New York Life, the assignee. All the rights under the ground lease and under the building lease were assigned to New York Life by both Frank Lyon and the Worthen Bank; is that correct? [154] A. Would you repeat that? If the question is: Was there an agreement, yes, sir.

Q. There was an assignment of all rights by both Frank Lyon and Worthen Bank under the ground lease and the building lease to New York Life? A. That's correct. Everybody assigned everything to New York Life.

Q. Did New York Life look to the viability—the economic viability of Worthen Bank in entering into this arrangement? A. Well, yes, sir, any lendor looks to the validity of a major tenant of its major security.

Q. You said everything was assigned to New York Life. New York Life then dictated a lot of the terms that would go into this arrangement? A. I'd hate to say "dictated".

Q. If there was a dispute you had the last word in a lot of instances? A. Usually our wishes were exceeded to.

Mr. Sayre: No further questions, Your Honor.

The Court: It's getting a little clearer. This Charles Smith——

The Witness: Yes.

The Court: —he is a specialist in this type of business? Is he or is he not?

The Witness: Judge, he's an assistant—at that [155] time he was assistant chief counsel for New York Life Insurance Company, I believe, of its property division and he had all the earmarks of a specialist. I don't know much of his background.

The Court: Did the other attorneys take their lead from him in terms of the structure? Who contributed most to the format: the identification of the number and types of agreements that would be used to consummate the transaction? Who took the leadership in getting the agreements together?

The Witness: Judge, I think Mr. Smith resolved disputes. Actually, the initiation of documentation was here in Little Rock between Mr. Giroir and Mr. Williamson and myself.

If we reached a hangup or impasse we couldn't resolve locally, we'd call Mr. Smith, or on occasions went to New York for conferences in New York.

The Court: All right.

REDIRECT EXAMINATION

By Mr. Giroir:

Q. Just one question. Is there anything in these documents which you find as a lendor's attorney would be unusual in a long-term loan secured by a long-term lease? A. No, sir. They were fairly standard documents.

Mr. Giroir: Thank you.

The Court: Anything else? May Mr. Dover be excused?

You may stand down and you may go as far as the Court is concerned.

[156] (Witness excused.)

The Court: We will resume with the cross examination of Mr. Cotham by Mr. Sayre.

Thereupon,

Ralph R. Cotham, Jr.

having been recalled as a witness by plaintiff, and having been previously duly sworn was further examined and testified as follows:

The Court: Let me ask you. Was this agreement and the structure of it presented to your board of directors at some time before it was reduced to a formal agreement?

The Witness: Your Honor, it was presented to the executive committee and I would make oral reports to the board of directors on it. I did not get into the legal technicalities in detail because, frankly, I didn't think I had the ability to articulate it.

The Court: Well, I was thinking more in terms of the practical effect in terms of the economics of it.

The Witness: Yes, I did do that.

The Court: Explain whether this would be a good deal for Frank Lyon?

The Witness: Yes, Your Honor, I did do that.

The Court: What you could make under the worst circumstances and what you might make under the most advantageous circumstances?

[157] The Witness: Yes, Your Honor.

The Court: Such an explanation was made?

The Witness: It was.

The Court: Before an agreement was entered into?

The Witness: Before an agreement was entered into, both the executive committee—probably in more detail to the executive committee and a general report to the board of directors.

By Mr. Sayre:

Q. With reference to that point, who owns the majority of Frank Lyon Company stock? A. The Lyon Family. Mr. Frank Lyon.

Q. How much stock does Mr. Lyon own—he or his immediate family? A. Mr. Lyon and Mrs. Lyon own right at 45 percent each.

Q. So about 90 percent total? A. Ninety plus, yes.

The Court: I am sure it is in here, but I have not read all these documents and I am going to pay attention to the ones you bring to my attention. When I saw what a formidable task it was when I started reading some of the fine print, I decided I would wait until you told me what was important and what was not.

Let me ask and maybe anticipate. There were balance-sheets submitted to the New York Life and First City National?

The Witness: Yes, Your Honor.

[158] The Court: And at approximately the time the commitment was made—let's put it this way: When the agreements were signed carrying out this, what was the net worth of Frank Lyon Company? Do you know?

The Witness: Between $3 and $4 million.

The Court: The net worth?

The Witness: Yes. As a matter of fact, I believe it's in the stipulation.

Mr. Sayre: Exhibit 34, I believe.

The Court: Let me see if I can find it here.

The Witness: Plaintiff's Exhibit 33, Your Honor.

The Court: As of December 31?

The Witness: As of December 31, 1968, our net worth was $3.8 million.

The Court: And did you submit profit and loss statements, too?

The Witness. Yes, Your Honor.

The Court: Are they following along?

The Witness: Plaintiff's Exhibit 34.

The Court: Very well.

By Mr. Sayre:

Q. Mr. Cotham, Exhibit No. 23, Plaintiff's Exhibit 23 is an assignment, I believe—excuse me, the building loan and mortgage. In that mortgage the Worthen Bank joined with Frank Lyon Company in assigning certain assets to First National City [159] Bank to achieve the interim financing.

The Witness: Yes, they did.

The Court: Now you are referring to which instrument?

The Witness: Plaintiff's Exhibit 23, Your Honor.

The Court: The building loan mortgage?

The Witness: The building loan mortgage.

By Mr. Sayre:

Q. And under Exhibit No. 24, Plaintiff's Exhibit No. 24, the Frank Lyon Company assigned all of its rights under the lease and under the ground lease to First National City Bank; is that correct?

The Witness: That's correct, as security for our loan.

Q. Now Mr. Giroir brought your attention to Exhibit 21, which is the building loan agreement, and that agreement evidences the agreement or arrangement between Frank Lyon Company and the First National City Bank? A. That is correct.

Q. And there are certain obligations. One is that Frank Lyon Company makes in that, beginning with paragraph 8,

I believe, that Frank Lyon shall furnish and cause to be furnished to the lendor on or before making final advance a certificate that the building was completed as required.

Number 9, that the borrower shall furnish or cause to be furnished or the lendor may procure at the expense of [160] borrower surveys.

Paragraphs 8, 9, 10, 11, 12, and 15 require the Frank Lyon Company to make certain agreements or certain warranties—let's see what it is actually titled—certain warranties to First National City Bank. Now if you will flip over to Exhibit No. 25, the sales agreement, this is the agreement that was executed approximately five days after the building loan agreement. This was an agreement between Worthen Bank and Frank Lyon Company.

If you will, begin at paragraph 3 under the covenants at page 7. All of the covenants that Frank Lyon Company has made to the City Bank under paragraphs 8, 9, 10, 11, 12, and 15 of Exhibit 21 are expressly warranted by Worthen Bank to Frank Lyon Company under paragraph 3(b), (c), (d), (e), (f), and (g); is that correct? A. I really do not remember without sitting down and reading them right now.

Q. I have read these documents and—in other words, these same agreements that Frank Lyon Company has made to First National City Bank are assumed by the Worthen Bank, the entity then constructing the building. Worthen Bank also was the entity that arranged with City Bank for the interim financing; is that correct? A. They made the initial contact. We negotiated with City Bank.

[161] Q. With regard to the Exhibit 13 it said the interim financing would be provided by First National City Bank and you were informed that permanent financing was also to be paid by New York Life; is that correct? A. Yes.

Q. Now Exhibit 25, paragraph 3(j) on page 8 states that the bank agrees to indemnify and save the company—Frank Lyon Company—harmless against and from any and

all claims by or on behalf of any person or persons, firm or firms, or corporation or corporations arising out of the failure to deliver the completed bank building to the company on or before the closing date, whether or not the bank is at fault in connection with such failure and unless the failure is a result of act or omission of the company, Frank Lyon.

By that provision, then, the Worthen Bank assumes all responsibility and agrees to indemnify Frank Lyon Company of any loss if any occurred on a failure to complete the building; is that correct? A. Sir, it does not relieve Frank Lyon Company from its responsibility. The clause here is a standard indemnity hold harmless clause.

Q. So, in any case, Worthen Bank was bearing the ultimate risk on construction of the building and the delivery of the building or the sale of the building rather than Frank Lyon Company? [162] A. As it says, they did agree to indemnify and hold us harmless. Rather standard clause in real estate transactions.

Q. And under paragraph 5 of that exhibit there is a default by the bank. "Prior to the closing date, the company at its option may require the bank to repurchase the bank building for an amount equivalent to the sum of all reimbursements paid to the bank under paragraph 2(b) plus all expenses incurred by the company"—Frank Lyon—"under paragraph 6, plus interest thereon at the rate of 10 percent per annum."

In other words, if the bank defaulted, not only were they going to hold you harmless but they were going to buy the building back and pay 10 percent interest on the money you had advanced; is that correct? A. At our option if they defaulted.

The Court: Prior to the closing date?

By Mr. Sayre:

Q. Prior to the closing date? And that date was November 30, 1969. A. Yes.

Q. So the risk, again, during the period of the construction was born by the Worthen Bank rather than the Frank Lyon Company? A. We were on the line too. We did have indemnity agreements an hold harmless agreements and an option or rights we ould exercise in case the bank defaulted.

[163] I think I would be derelict in my duties as an officer of the company if I didn't insist on that.

Q. Paragraph 10 on page 12 of that exhibit states: "For so long as the bank is not in default with respect to its obligations under any of the exhibits, the bank shall have the sole and exclusive right to determine the name of the bank building," and the bank will have an irrevocable general election conforming to the requirement of Section 48 of the Internal Revenue Code of 1954, as the same may from time to time be amended, to treat the bank as having purchased any property which is purchased hereunder during the taxable year, and to perform such other acts with regard to Section 38."

This is in regard to the investment credit; is that correct? A. Yes. Section 38 is investment credit property.

Q. So even though you say Frank Lyon Company is putting the money into the building as it drew it down and was the owner of the building, you agreed to pass all investment tax credit, sales tax savings, on to Worthen Bank? A. That's correct.

Q. And Worthen Bank bore the ultimate risk of the construction of the bank; is that correct? A. We have an indemnity and hold harmless clause from them, yes.

Q. Mr. Dover just said that everybody assigned everything [164] to New York Life. Under Exhibit No. 27, the deed of trust Frank Lyon Company assigned its interest in the building lease, the ground lease, and the building to New York Life, and Worthen Bank assigned its interest in the land and garage; is that correct? A. That's correct.

Q. And even though it was your debt, Worthen Bank subordinated or added additional security to the debt of about $4 million of its own property. A. They subordinated the parking garage and the land. I don't know the value.

Q. Then I think it was a million four and a million two, about two million six. A. Like I say, I'm not familiar with the value.

Q. Under Exhibit No. 29, which is the Worthen Bank's consent and agreement with New York Life, they agreed to keep New York Life posted under paragraph 3 by giving them current balance sheets each year; is that correct? A. What page is that on, please?

Q. Paragraph 3.

The Court: Which agreement?

Mr. Sayre: Exhibit 29.

The Witness: In the consent and agreement.

Yes, that's correct.

By Mr. Sayre:

[165] Q. And all of these negotiations were—again, all of these instruments were tied into each other. They are interrelated. The terms of the deed of trust and the building lease and the ground lease are all interrelated. They are really all part of one basic transaction to build the Worthen Bank Building? A. Yes.

Q. Let's turn to Exhibit No. 19. A. Plaintiff's Exhibit 19?

Q. Plaintiff's Exhibit 19, which is the building lease itself. This is what is termed in real estate parlance a "net" lease; is that correct? A. That is correct.

Q. All obligations are upon the lessee to care for the building? A. Change the light bulbs.

Q. Pay for all expenses? A. Pay for the insurance and taxes. It is a net in real estate parlance.

Q. And the ground lease also places all the burden and responsibility for the upkeep of the land and paying the taxes and the indemnification of the Company, Frank Lyon Company, upon the Worthen Bank; is that correct? A. Yes, that retained those responsibilities as owner of the land.

Q. And again that was $50 for 25 years? [166] A. For the first 25 years, and then went up to $250,000 a year.

Q. Now if you will, go to paragraph 3.1 of that agreement.

The Court: Of the building lease?

Mr. Sayre: Yes, Your Honor.

The Court: What page is that?

Mr. Sayre: Page 2.

The Witness: Page 2, Your Honor.

The Court: All right.

By Mr. Sayre:

Q. That is the agreement to pay the lease—excuse me, to pay the rentals to—by Worthen Bank to Frank Lyon Company in an amount equal to the debt service; is that correct? A. This agreement is for Worthen Bank to pay Frank Lyon Company rent on the building.

Q. Which is an amount equal to the debt service of Frank Lyon to New York Life? A. These amounts are the same as the obligation to renew our note.

Q. May I ask why there is an increase in the payment after 11 years. A. This was part of the original arrangement and specification of sale and leaseback as Worthen Bank submitted to us on Plaintiff's Exhibit 13, paragraph 2. Each rental payment to be [167] required, 1 through 11 at lower rates and "B" is 11 through 25 at a higher rate.

Q. They are not the same amount, are they? A. Those are quarterly. I think there may be a little difference.

Q. But do you know why you negotiated difference in there? A. No, sir, I don't recall. The difference is pretty immaterial. Over a half million dollars in annual rent, it's less than a couple of thousand dollars.

Q. In paragraph 3.2 on the next page it says that the basic rent shall be absolutely net to lessor or assignee so that this lease shall yield to lessor or assignee the full amount of the installments of basic rent throughout the term of this lease without deduction. A. Yes, sir.

Q. Worthen Bank, then, had an absolute obligation to pay rent for the 25 year term of the lease. A. That's correct, without deduction.

Q. Now on section 5.1 of that page it also says that the basic rent, additional rent and any and all other sums shall be paid without notice, demand, counterclaim setoff deduction or defense and without abatement.

In other words, if your loans to Worthen Bank had gone bad, Worthen Bank could not set off the rent payments that they owed to you against the amount that you owed to them? [168] A. That's correct.

Q. Was this requirement put in here by New York Life who wanted to make sure they got their money? A. Section 5.1 was negotiated between the three parties.

Q. Again, going through this, the Section 7.1 the repair and maintenance of the premises were all upon Worthen Bank? A. Yes. "Lessee covenants throughout the term of this lease to take good care of the property and to keep it in good condition, excepting reasonable wear and tear."

Q. Section 11.1, which is on page 6, is another indemnification by the lessee of the lessor? A. Yes, indemnification and hold harmless clause.

Q. So Frank Lyon Company did not bear the ultimate risk of the operation of the building. If any suits were brought or any accident, injury, damage, so forth, against the lessor, Frank Lyon Company, Worthen Bank would accept the responsibility and the risk; is that correct? A. It would not relieve our legal responsibility. We could in turn look to Worthen for indemnification.

Q. And they had also agreed to indemnify you on the ground lease? A. Yes.

Q. Now on page 11 there is a sub-section 15.1—— A. Are we still on the building lease?

Q. Yes—which refers to the change and alteration [169] by the lessee. Under the terms of this arrangement, the bank was entitled to make changes that it desired in the bank building and if certain amounts were over and above a certain amount—the costs—then they would have to hire an architect or hire engineers to oversee it at your demand? A. That is correct.

Q. This same provision is contained either in the consent agreement or the deed of trust that if alterations are made that Frank Lyon Company would have to provide New York Life with the same assurances.

So, in other words, again we have responsibilities of Frank Lyon Company to New York Life being assumed by Worthen Bank; is that correct—the ultimate responsibilities? A. No, they are not assumed. Worthen Bank may have the same responsibility to us, but we are not off the hook.

Q. You would have to incur the cost of this? A. Yes.

Q. It would not be paid for by the lessee? A. We would require them to do it, but if they don't do it we have to pay for it under the deed of trust.

Q. But they would have to fail to keep their obligation under the terms of the lease? A. Yes.

Q. Under Section 17 on page 16, there is an agreement by the Worthen Bank to repair any damage or destruction to the [170] property. Therefore, the risk of repairs, and so forth, are upon the Worthen Bank and not the Frank Lyon Company to make any repairs or restructuring of the building; is that correct? A. Except for total destruction, yes.

Q. And under 17.2 the insurance money recovered on account of damage would be applied to the obligation of

the lessor, which is Frank Lyon Company, or the assignee, which is New York Life; is that correct? A. "Except as provided in Section 17.6 all insurance money recovered by lessor or assignee on account of such damage"——

Q. Paragraph 17.6 refers to the total destruction of the building, I believe, and that is a different obligation there.

So all risk is born by Worthen Bank rather than Frank Lyon Company during the term of that lease; is that correct? A. I'm sorry. Would you restate the question?

Q. The risk of damage, repair, and cost of insuring the property for the period of the time of this lease, initial term of this lease, is—in fact, I suppose for all time, that for the initial term of the lease—is upon the Worthen Bank and not the Frank Lyon Company? A. For the entire 65 year term of the lease, yes.

Q. Under 17.3, which is on page 18, it is the Worthen Bank's obligation to make payment of the basic rent and all items of additional rents and other charges on the part of the [171] lessee to be paid and to perform all covenants and agreements to be performed and these shall not be affected by any destruction or damage to the property. The bank waived the provision of the statute or law which would have a contrary effect.

In other words, there is an absolute obligation on the part of the Worthen Bank to pay a quarterly rental payment to Frank Lyon? A. To Frank Lyon Company, yes.

Q. Which in turn has an obligation to pay the exact amount over to New York Life? A. Yes. I think that's consistent with Section 5.1 which is the counterclaim abatement that we discussed earlier.

Q. Under 17.6, which is on page 19, if there was total destruction of the building on or after the initial 22 years of the lease, the board of directors of the bank shall decide whether to replace the building or to purchase the building from Frank Lyon or the assignee for an amount equal to the figures set forth in Table A, which is the purchase price,

if there is destruction of the building; is that correct? A. Yes.

Q. In other words, it's another option that the bank had if the building was destroyed. A. Total destruction, that's correct.

Q. Under 18.2, which is on page 20, they have the same right or the same option to purchase if the building is [172] condemned; is that correct? A. Yes, that is correct.

Q. On page 32, Section 29.2 it's understood and agreed that all rights under this lease will be assigned to New York Life as security for the note purchase. In other words, it's all part of the same transaction? A. I'm sorry. What paragraph again?

Q. It's 29.2 on page 32. A. Yes, that's an acknowledgement by both the lessor and the lessee that the lease will be assigned to New York Life as security on our note.

The Court: I'm just wondering if it might not be a better procedure unless you have some particular questions of the witness other than for him to identify the language, which speaks for itself and as to which the Court can read, maybe we could speed it up a little bit if you would identify each section you want the Court to read.

If you want to question the witness about the provision, that's fine; but just to ask him if a section does not say so and so, I think we could move faster. I do want you to, however, point out every section of these agreements that you want me to read. But I can do some of this outside the courtroom.

Mr. Sayre: Thank you, Your Honor.

By Mr. Sayre:

[173] Q. It's a fair statement to say that the ultimate risk with regard to the operation of the Worthen Bank Building are born by the Worthen Bank, not by Frank Lyon Company, due to the indemnification? A. The operation of the building?

Q. The operation of the building. Actually, the suits against it, against accidents in it, any obligation. The only thing that Frank Lyon Company actually has is their legal title. Is that correct? A. No, that's not correct.

Q. What else do they have? A. We've got $7,640,000 building. We've got a lease on that building, which is a net lease. We have extracted indemnity and hold harmless clauses against the tenant.

Q. Which, in effect, leaves Frank Lyon with the legal title to the building and no responsibilities—other responsibilities and risks attendant to ownership. A. No, sir, that is not correct.

Q. What other risks of ownership are born by Frank Lyon Company? A. The same risks that any landlord has of a tenant that doesn't live up to its obligation.

Q. You are saying that you assume that Worthen will default on its obligation? A. It's' entirely possible. We don't think so or we [174] wouldn't have entered into this agreement. But if they do, we are still liable to New York Life.

Q. The tax shelter created by the interest and the double declining depreciation deduction was one of the primary reasons? A. It was a factor that we considered.

Q. It was an important factor? A. Was it an important factor?

Q. Was it an important factor? A. Not especially, no.

Q. Then what in your opinion as a representative of the company was the important factor? A. The objective of the corporation to diversify.

Q. Even though title could be taken from it and any appreciation in value, or equity buildup could be taken from it by the bank? A. They'd have to give fair consideration for it. They did have an option to repurchase on four special dates in a 75-year period.

Q. In a 25-year period? A. Well, the ground lease runs for 75 years.

Q. But it can also be cancelled if the option is exercised on the building; is that correct? A. To purchase the building?

Q. Yes. A. Yes.

[175] Q. So, in other words, it all cancels at the same time, dependent on what the bank does? A. It depends entirely on the bank.

Mr. Sayre: Excuse me just a moment, Your Honor.

I have no further questions.

The Court: All right, Mr. Giroir.

REDIRECT EXAMINATION

By Mr. Giroir:

Q. Ralph, on this Coke loan that we have discussed, let me clear the air on that. Was there any conversation, agreement, understanding or other discussion between Frank Lyon Company and Worthen Bank that ir any way related the Coke loan to the credit judgment of Worthen Bank to tht building? A. Absolutely none.

Q. Is it your intention to repay the Coke loan? A. Oh, yes.

Q. When? A. We may be able to do it next year. Perhaps this year, '74. Maybe '75.

Q. It's been outstanding for some five years? A. Five years, yes.

Q. Did Worthen understand at the outset that it was going to be renewed annually? A. Yes, they did.

Q. Why did they exceed to that? How did you explain the [176] need for making it a five year loan? A. An analysis of the cash flow of Frank Lyon Company showed [we?] me perhaps could not pay it for a period of five years. As Defendant's Exhibit 18 shows, we had loans totaling $2,307,000 to the ex-Coca Cola shareholders. These required principal payments in four equal installments for a four-year period. That would be approximately $600,000.

Our agreement with Republic National Bank was to make 10 percent reductions of principal annually. That is approximately a quarter of a million dollars that we had in principal only that we had to pay the Republic National Bank. If you add those two together, that's about $850,000 in principal only.

We had to pay under the loan to First National Bank another approximately $50,000 and another $500,000 loan to Worthen, additional $50,000 annually. So when you have principal payments in one year on your debt service approximating a million dollars, plus interest on top of that, we just weren't sure we could make any reduction in that half million dollar note.

The Court: Was there any legal commitment made by Worthen to renew, or was this just——

The Witness: No, Your Honor, it was—we did ask for a one-year note and expressed to them at that time the cash bind that we would be in and said, "We might come back and ask you to renew the note."

The Court: Well, what if they had not renewed it? [177] Would you have any legal position?

The Witness: We would have no legal position at all. It would be a default under that note and we'd have to—it was not a secured note, Your Honor, but we would have had to go to another bank and borrow the funds or perhaps sell other assets to pay the note off. There was no legal obligation on Worthen's part to renew the note.

By Mr. Giroir:

Q. Was Worthen aware of all of these other commitments you had? A. Yes, they were.

Q. As a matter of fact, did you at this time have a line of credit with Worthen? A. Yes. Throughout this entire time we had a line of credit with Worthen, and still do.

Q. What was the amount of that line? A. Depending on that time somewhere between a million and two million line of credit.

Q. Would it have been possible for you to have drawn down on that line of credit and paid down on this note? A. Yes. It would have been, unless the same factors that would cause them to fail to renew might have caused them to cancel the line of credit also.

Q. You had explained to them had you not, that it might be some period of time? [178] A. Yes. As a matter of fact, it would probably be at least five years because of the very heavy debt service on the note to the ex-Coca Cola shareholders.

Q. Was the net worth or the aggregate of the four or five notes to the ex-Coca Cola shareholders secured by anything? A. Secured by all of the stock in the Coca Cola Company.

Q. In point of time, just for frame of reference now, when was Coca Cola purchased? A. August the 21st, 1969.

Q. Going back to 1968, when was the Twin City Bank stock purchased? A. In June of 1969—'68. I'm sorry. In June of '68.

Q. The question was asked earlier whether or not there was any connection between the purchase of the Twin City Bank stock and your commitment to purchase this building? A. Absolutely none.

Q. Your commitment to purchase this building was entered into on what date? A. Oh, our proposal was accepted around November the 1st of 1967.

Q. And have you, since your testimony earlier this afternoon, determined when Henry Tupp, the principal stockholder of Twin City Bank, died? A. He died in November of 1967, and it was in the spring of 1967 when—late spring or early summer when the executors [179] of his estate elected to sell Mr. Tupp's stock or the estate stock in Twin City Bank.

Q. Was there any connection between your commitment to buy Twin City Bank stock and your commitment to buy the Frank Lyon Building? A. None whatsoever.

Q. Now the proposal which you made which was accepted—your second proposal to Worthen Bank—indicated that you would reduce the lease payment to an amount $21,000 per quarter per year — A. Per year.

Q. ——less than the note payment? A. That's correct.

Q. In fact, is the lease payment $21,000 a year less than the note payment? A. No, it's not. We tried to do this and agreed with Worthen to sign a lease to that effect, but New York Life would not accep. our assignment of the lease with that provision in it.

Q. Then did Worthen forego its $21,000 a year? A. No, they did not.

Q. Did you have any proposal as to how you would get that $21,000 a year to them? A. Not at that time. We were spending 40, 50, 60 hours a week really negotiating these documents, and we agreed with Dick Gates that the most important thing was to go ahead and [180] get this transaction closed and then we'd worry about it.

Shortly after that I had suggested to Frank Lyon to go ahead and write them a rent rebate check in December of some $21,000.

Q. Is that $21,000 each year? A. Yes, for a four or five-year period.

Q. What was his response to that? A. He didn't think much of that idea.

Q. Why not? A. He felt like this would really be an agreement outside of the lease payments or the rental payment—the lease we had signed with Worthen Bank and which we had assigned to New York Life—and there ought to be a better way to get the $21,000 to Worthen.

Q. Did he still recognize the obligation to pay the $21,000 a year? A. Yes, he did, and suggested that I find out a way to get the $21,000 to them before the end of the year.

Q. Did you have a proposal in that respect? A. Not at

that time. However, in about August of 1969 when I realized that we were going to have to borrow some additional money from Worthen Bank and furthermore that we would not be able to pay it back as fast as we had our other borrowings, the idea popped into my head of suggesting maybe in the negotiating allowing Worthen to charge us or consenting to [181] Worthen's charging us more interest than we normally pay to Worthen.

Q. You mean pay a higher rate? A. Yes.

Q. Did you have outstanding loans to Worthen at that point? A. Yes, at that time we did. We had borrowed a half million dollars in late '65 or '66 which were retiring at $12,500 a year as shown in Defendant's Exhibit 18.

Q. Did you renegotiate that loan to agree to pay additional interest on it? A. Not the outstanding one, we didn't.

Q. Did you agree to pay additional interest on any loan? A. We did agree to pay additional interest on the $500,000 that we were about to borrow in order to pay the down payment to the ex-Coca Cola shareholders.

Q. How much in percentage? How many additional percentage points did you agree to pay? A. It was around three and a half percentage points more than we normally were asked to pay. Normally we were able to borrow money at Worthen's prime rate, and at this particular time it was around six percent. We negotiated that note at around nine and a half percent. Maybe prime was six and a quarter.

Q. What is that? Approximately three and a half percent on $500,000? [182] A. Three and a half percent on $500,000 was close to $20,000.

Q. Did you intend to continue to pay that excess amount of rent over the full period of time of your commitment? A. Actually, it worked out very, very well for us because as I have testified earlier the notes to the Coca Cola shareholders were due in four years and we would really, from an economic standpoint, not be able to pay any. So when

we had explained this to Worthen, that was an additional reason that we used to induce them to continue to renew the note over the five-year period.

Q. When you say "that", what do you mean "that was"? A. Our commitment to reduce the rentals by approximately $21,000.

Q. And when does that five years expire? A. '69 to '74. I think it's in December of this year, as a matter of fact.

Q. So that if you pay excess interest over five years you will have compensated Worthen? A. That's correct, if you take six percent as a fair rate of interest.

Q. During the construction period while you were borrowing from First National City Bank, how did you mechanically handle the payment of the interim interest obligation? A. We—the note calls for a monthly adjustment of the [183] interest rate, according to First National City Bank's best commercial rate in existence at the first of the month.

They would send us notification as to what this rate was as well as the principal amount outstanding and we would write a check and mail it directly to New York—First National City Bank in New York to pay the invoice.

Q. How was it paid? A. Monthly as required by the building note.

Q. Mr. Sayre asked you if there was a cash flow during the first 25 years of the building and your response was, "No." Were you speaking in terms of a before or after tax? A. I was speaking in terms of a before tax cash flow.

Q. Was there an after tax cash flow? A. Yes. As I testified there was a cash flow during the first 11 years of approximately one and a half million dollars. Likewise, a negative cash flow of perhaps a little less than that in the subsequent 15 years, 14 years.

Q. In your experience in the real estate investments, is it unusual for there to be no positive pre-tax cash flow? A. Not at all. As I have already testified, in all of our real

estate investments that I am an officer in the corporation there is no substantial cash flow. The debt service and the rental payment are not identical. The differential between the two is only sufficient to pay a nominal management fee to Frank Lyon and to pay the franchise tax to the State of Arkansas.

[184] Q. Your $500,000 "equity" in the building represents, I suppose, what percent? Approximately seven percent of the total cost? A. Yes, approximately seven percent of the total cost.

Q. And in your experience in real estate investments is it unusual to borrow out 93 percent on a real estate project? A. Not at all.

Q. Is it unusual to borrow more? A. Some people have been known to borrow more. Some people have been known to borrow a hundred percent.

The Court: Or maybe even more than a hundred percent.

I think we better have a break. We will be in recess until a quarter to 5:00, and then we will go to 5:30. I think that is all we can do in terms of imposing on the court reporter.

(Recess.)

The Court: Let me find out a little bit about the $21,000. The Frank Lyon Company in trying to get this project tried to underbid——

The Witness: Yes, Your Honor.

The Court: ——and they were not privy to what the other interested parties were doing and so they wanted to try to anticipate and offer something to Worthen that would make it sure they got the package; is that correct?

[185] The Witness: Correct.

The Court: Now as it turned out, are you saying that New York Life did not want, in effect, the investor agreeing to a rental that was not at least enough to pay the principal and interest payments required; is that correct?

The Witness: That is correct.

The Court: So the documents were executed accordingly.

The Witness: Correct.

The Court: Now, then, you are saying when your boss was saying, "How could we honor this commitment," it was discussed to write a rebate check every years for 25 years?

The Witness: Correct.

The Court: Is this Mr. Lyon that did not want to do that?

The Witness: Yes, it is.

The Court: When all these documents were entered into here it was in what, May of '68?

The Witness: May of '68, Your Honor.

The Court: So what happened? Did this just hang fire about how to handle this problem?

The Witness: Yes, it did, and I was supposed to solve it before the year ended.

The Court: And you did not, or did you, before that year?

Mr. Giroir: Your Honor, the first lease payment wasn't [186] due until March of '70.

The Court: I see.

Mr. Giroir: So the problem didn't become a reality until then.

The Court: I see. It became a problem after March of '69.

Mr. Giroir: March of '70. The building was completed in November of '69 so the first rental payment was——

The Witness: Three months later.

Mr. Sayre: March of '70.

The Court: So eventually when the opportunity for the Cola Cola stock came along and you had to borrow money you, in effect, paid more than you had to or would have ordinarily had to in order to perform on your agreement or your commitment to Worthen?

The Witness: That's correct.

The Court: And it was just something that was to be renewed on a year-to-year basis and as it, in fact, worked out you expect this commitment will be discharged by five renewals of that note?

The Witness: Just the way the circumstances worked out. The ex-Coca Cola shareholders demanded their installments over four years and this did sap us for four years and we really needed to borrow the money for five years anyway. It did so happen that was also the length of time we had promised to reduce [187] their rent.

The Court: In the dealings was Worthen insisting upon this and saying, "All right. Let's get this behind us but after all, you made this agreement," or do you know anything about the actual negotiations with Worthen about this $21,000 other than the report to you that, "We need to work out something to pay it and you figure out a way." Besides that, were you in the negotiations with Worthen about this matter?

The Witness: Only to the extent that we first went in and, "We'll reduce the lease payments in the lease by $21,000."

The Court: Until New York vetoed it?

The Witness: Until New York vetoed it. At that time I dropped it. I was working full time on this deal.

The Court: I don't know that Worthen will be interested in dropping some hundred thousand dollars without some understanding. Do you know how that was picked up by Worthen?

The Witness: No, I do not.

The Court: You may continue, Mr. Giroir.

By Mr. Giroir:

Q. Mr. Cotham, for the purposes of identification let me refer you to Defendant's Exhibit 18. You've got circled at the left top the year 1969. A. Yes.

Q. There is a loan designated "Journal Entry, J E"—— A. Zero 080. We use five digits. We have so many journal [188] entries during the year we use five digits to designate them all.

Q. There is a designation "Stockholders C A C". A. That's Coca Cola.

Q. $2,700,000. A. That's correct.

Q. It's your statement this is the loan to the Coca Cola stockholders? A. That is correct. The ex-Coca Cola shareholders.

The Court: How much was that?

The Witness: $2,307,074.

By Mr. Giroir:

Q. Is that the loan or the aggregate of the loans you agreed to pay over a four-year period? A. That's' the total of the notes over the four-year period.

Q. On the following page next to the bottom there is a journal entry that bears the same number designated "Worthen Coca Cola" in the amount of $500,000. Is that the $500,000 loan from Worthen Bank obtained to fund part of the down payment for the Coke stock that we have

been discussing. A. That's correct and so identified in two places. The journal entry is identical and, secondly, to distinguish this from the other Worthen Bank loans it's designated "Worthen-Coca Cola".

Q. Who owns the balance of the stock of the Frank Lyon Company? [189] A. Some of it is held in treasury stock. Approximately--I think Mr. C. W. Abrams owns around five percent and there are about four other officers that own less than one half of one percent, and Frank Lyon, Jr. owns approximately one or two percent himself.

The Court: How much?

The Witness: Frank Lyon, Jr. owns approximately one or two percent, Your Honor.

By Mr. Giroir:

Q. C. W. Abrams, is he an officer of Frank Lyon A. Yes. He has been with the company since the 1940's and is now president of the corporation.

Q. All of the stock, other than that owned by Frank Lyon and Marion Lyon, his wife, then, is owned by employees of the company? A. Yes, with the exception of some of the Lyon stock that I believe has been given to other family members as trustee as part of their estate planning.

It's all owned by members of the Lyon family in trust of which they are beneficiaries, with the exception of less than ten percent which is owned by other officers of the company; the primary officer being C. W. Abrams, who owns approximately five percent.

Q. As to the increase or decrease in the value of the building over the term of these leases, I call your attention [190] to the fact that your ownership is of the building only and, therefore, no increase or decrease in the ground valuation has an effect on the value of the building. A. That's correct.

Q. How did that figure into your determination on the front end of what the building would be down the line? A. Mr. Giroir, it made it quite a bit easier to try to determine. You could look back in 1967, '68, and see what land values had done in the preceding 25 years and realize what a difficult thing it was to try to look out for 10, 15, 20, 25 years to really estimate what the fair market value of the land would be.

When you are purchasing and owning a building, which is depreciable, it's a little bit easier to quantify.

Q. What effect on that determination, prospectively of what the fair market value would be, did the existence of a long-term lease with renewal options have? A. It certainly had an effect on it. The fact that we, as owner of the building, had executed a long-term lease, which at the sole option of the tenant, could be extended as long as 65 years would certainly—would be a factor in determining the value of the building.

Q. Would that same factor be considered by a purchaser? A. Absolutely.

Q. This unusual arrangement by which you purchased the [191] building on a brick-by-brick basis, was that at your suggestion or Worthen's suggestion? A. Not at all. I was really hoping we could see the finished product and then buy it from them. It was solely at Worthen's suggestion that we do it on a brick-by-brick basis.

When I pushed them on it I learned that there were two reasons for this: one was to escape the provisions of the Arkansas Sales Tax. In other words, if they continued on with their contracts, purchased the materials that were put in the building, those materials would not be subject to Arkansas Sales or Use Tax at that time.

Frank Lyon Company was subject to the sales tax provision and, therefore, would have to pay additional three percent of—don't know what portion of the total cost was labor or materials. Even three percent of $4 or $5 million would be $150,000.

The other one, which Mr. Dick Gates told me, was the concern of the Worthen bank officers in not having this for an excessive amount of real estate appear on Worthen's books. They did not want to wait until the building was completed. They wanted us to start taking title to it now, immediately.

Q. Did that unusual arrangement have any effect on the type of protective covenants you obtained from Worthen? A. It certainly did. We didn't know, number one, whether Worthen was going to complete the building. We didn't want to [192] buy a pig in a poke. Had we been able to wait until the building was completed we would walk around and see what it looked like and get structural engineers to certify that the building is going to stand up in hurricanes or tornadoes or other types of rains, but know that the roof doesn't leak and the elevators work, and that it is a functional building.

Q. Did that relationship give rise to the indemnification provision which Mr. Sayre was questioning you about? A. It certainly did. That was the only way, really, that I could see as a viable option that Frank Lyon Company could protect itself.

Q. As to these provisions we have discussed on damage, destruction, condemnation, what was your question for being so hardnosed about that? A. Well, as an officer of Frank Lyon Company I was trying to make the best deal I could for my employer.

Q. Do you think you protected him in that regard? A. I certainly tried to do so. Hope so.

Mr. Giroir: I have nothing else, Your Honor.

The Court: Mr. Sayre.

RECROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Cotham, in regard to the other types of rentals or buildings or leasing arrangements that Frank Lyon

family has, do those involve options to purchase also? [193] A. I cannot recall. There may be one that does.

Q. So, in other words, there are not leasebacks—— A. For the main part, that's right.

Q. And there's a small, minimal cash flow on these.

With regard to Mr. Abrams' stock in the Frank Lyon Company, is there an option to repurchase if he should leave the company? A. Yes, there is.

Q. You said that the $500,000 loan made in August of 1969 was unsecured? A. That's correct.

Q. So were the other loans secured, or were they all unsecured? A. No. The other half million loan, which we negotiated I think, in '66 with Worthen Bank, was unsecured. The half million dollar loan to First National was unsecured. The Republic loan was secured by the stock that we had purchased in Twin City Bank and the loan to the ex-Coca Cola shareholders was secured by stock. The note to Whirlpool was unsecured and the $114,000 on notes payable was unsecured.

Q. You said with regard to the $500,000 loan that there was not commitment, no understanding with relationship to the bank of Frank Lyon Company buying the bank. A. That's correct.

[194] Q. Now you come back and tell the Court there was an understanding to pay higher interest with regard to that loan so as to make a kickback of $21,000 per year for approximately $21,000 under the agreement that had been reached in October or November of 1967. Is that your testimony? A. No, I don't think you have fairly summarized it.

Q. What was your testimony? They were interconnected because of the agreement to reduce the rental? A. They were not related at all. We did have an obligation——

Q. Then the nine percent interest has nothing at all to do with the reduction of the rental or anything else; is that correct? A. In our letter in November of 1967 we promised to reduce the rental payments during the five-

year period of $21,000 annually. We tried to execute a lease.

Q. I understand that, Mr. Cotham. My question is: Is there a connection between the loan? A. No.

Q. Then the nine percent interest has nothing to do with the payment of $21,000 in reduction of the rentals in the agreement to buy the building; is that correct? A. The difference between a six percent—approximately six percent prime rate at that time and nine and a half that we did pay, does——

[195] Q. Is it nine or nine and a half? A. I don''t recall. There was about a three and a half percent spread, and I do not recall whether prime at that time was six or six and a quarter.

Q. My question again is: There was a connection, then, between the loan and the payment of the interest on it and the agreement to hold it out connected with the agreement of Frank Lyon Company to purchase the Worthen Bank Building? A. No, not at that time. The loan was made to pay the down payment to the ex-Coca Cola shareholders and, in fact, that's where the proceeds went.

Q. You are saying the payment of interest—there is no relationship between that loan and the prior agreement of Frank Lyon Company?

The Court: As I understand his testimony, that at the time of the first transaction the Coca Cola transaction was not even under consideration but it became the vehicle to discharge this obligation that they committed themselves to at a later date when it arose.

The Witness: That's correct, Your Honor.

By Mr. Sayre:

Q. What I'm asking is: Is the payment of part of what is called interest to Frank Lyon really a reduction of the rental payments? A. Economically it has the same effect. We are paying [196] interest.

Q. Was it intended to be a reduction of the rent? A. No. It was intended not to be a reduction of the rent because they had an agreement with New York Life that we could not and would not reduce the rents.

Q. What I'm asking is: Frank Lyon deducted that additional payment of $21,000 a year of interest on their income tax return and the Government paid half of it. A. The Government didn't pay any of it.

Q. By taking the deduction on interest? They got a deduction at the forty-eight percent bracket, didn't they? A. Interest is a deductible expense.

Q. And so in effect, because of the tax rate what you are saying is that the reduction was paid for half by Frank Lyons and half of it was paid by the Government through a tax reduction. A. No.

Q. What I'm asking you is—— A. The rent——

Q. ——was the amount paid intended to be interest or was it a reduction on the rental? A. It was intended to be interest and was so negotiated and so stated on the face of the note.

A factor in negotiating the rate of interest was our prior obligation to reduce the rentals by approximately $21,000.

[197] Q. But you say there is no connection with the renewal each year of this with regard to the fact Frank Lyon Company put $500,000 into the construction? A. Even if Frank Lyon Company had not agreed to reduce the rentals by $21,000, we would have wanted to borrow that money for a five-year period. This was dictated by the——

Q. And that five-year period expired in August of 1974, and it has not been paid; is that correct? A. That's correct.

Q. And it's been renewed for another year? A. I believe that's correct, or we might have changed the maturity until December. We may renew it again.

Mr. Sayre: No further questions.

The Court: Anything else of this witness?

Mr. Giroir: Just one question, Your Honor.

REDIRECT EXAMINATION

By Mr. Giroir:

Q. As far as you know, did the $21,000 in additional interest have anything to do with the credit decision? A. Absolutely not. As a matter of fact, it would have to be—you know, four percent of a half million is only $20,000, so it does not exactly correlate to any $21,000 rent reduction.

Q. Now there was some discussion there a minute ago about the Government paying half of that $21,000. Isn't it [198] true it's in effect, a wash? How does it wash out? Does the excess rental wash against the excess interest as far as taxes are concerned? A. It would. I would have the—that's right. The tax effect is the same as if New York Life would accept an assignment of a lease which had $21,000 less rentals in the first five years. Exactly the same.

The Court: You may stand down.

(Witness excused.)

The Court: Call your next witness.

Mr. Williamson: Plaintiff would like to call as its next witness Mr. Edward M. Penick.

The Court: Mr. Penick, come forward, raise your right hand, and be sworn.

Thereupon

Edward M. Penick

having been called as a witness by and on behalf of Plaintiff, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

By Mr. Williamson:

Q. Will you please state your name and address? A. Edward M. Penick, 13540 Rivercrest, Little Rock, Arkansas.

Q. How old are you, Mr. Penick? [199] A. Fifty-two.

Q. What is your present position with Worthen Bank? A. I'm chairman and chief executive officer.

Q. And how long have you held that position? A. I have held that position since the early this year.

Q. And prior to 1974 what was your position with Worthen Bank? A. Most recently I was president and chief executive officer, and I have held various positions prior to that time.

Q. Between 1961 and 1974 were you president of Worthen Bank? A. Yes, sir.

Q. And chief executive officer? A. Yes.

Q. Would you please briefly state what your prior educational and professional training has been? A. I graduated from Little Rock Central High School, the University of Arkansas College of Business Administration and University of Arkansas School of Law.

Q. And have you had any professional training in banking and formal training in banking? A. I completed the Graduate School of Banking at Rutgers University and the School of Bank Marketing and Public Relations at Northwestern University.

Q. What offices in banking associations or organizations [200] have you held, Mr. Penick? A. I have been president of the Arkansas Bankers Association and president of the National Banking Association known as the Bank Marketing Association.

Q. Moving, now, Mr. Penick, to the background of the move into a new building, will you please state briefly what building you occupied prior to moving into the new Worthen Building and what lead you to a desire to get

out of that building? A. Prior to the time we moved into the present Worthen Building, we were in the building at 401 Main Street which we had occupied since 1929, at which time we were about a $3 million bank when we moved into that building. We had grown to about $107 million bank at the time we moved into our present building. We had remodeled the 401 Main building twice.

We had built a drive-in and parking facility and office facility behind it or had leased it. It had been built by other people, but we leased the parking and drive-in facility. We were at that time completely out of space and were faced with the problem of remodeling again, adding to, building on, or building a new building.

Q. Incidentally in the old facility did you own the parking deck that became an integral part of the building? A. No. We were a tenant of the parking deck. There was a separate organization. We leased the ground floor where [201] we had our drive-in. They built some office space along the fourth street side, and we leased all the office space and sublet the office space to some tenants but utilized most of it ourself. But the parking people operated it as a commercial parking garage.

Q. And these were people who had no connection whatsoever with Worthen Bank? A. Yes, sir.

Q. When did you begin to make plans to move out of your own building? A. We talked about it, I guess, for about two years, 1962-1963 and '64 and there was some difference of opinion among our board of directors. Some of the older directors said "You can't leave Main Street. Your corner is at Fourth and Main." At that time, Blass Department Store was still in existence and Fourth and Main was probably the number two corner in the City.

Many of the other directors felt like we couldn't build the type of facility we wanted to have on that corner even if we could acquire the adjoining theatre and other properties. We put out some feelers to determine if we could

acquire the theatre, and the price that came back to us was non-acceptable. So in order to resolve exactly what we should do, we retained a real estate consultant firm named James Landauer Associates of New York City to advise us on what we [202] should do, where we should go, how big we should build it, and how to finance it to be consultants to help us in this major decision.

Q. What were their recommendations, first with reference to the location of the building?

The Court: Describe the Landauer firm.

The Witness: Their title is real estate consultants. They don't do any building. They are a very fine firm, very well recognized firm. They have done a good bit of work in this part of the country.

First National Bank of Memphis is the place that we got their name. They had done the analysis of their problem. They had a similar problem, and I think they are one of the top real estate consulting firms in the country.

The Court: Very well.

By Mr. Williamson:

Q. And what was their recommendation with reference to the location and size of the new facility? A. They recommended that we attempt to acquire the three-quarter block site where our building is now located and that we build a 10 story office building.

Q. Did they also make any recommendations with reference to finance? A. Yes, they made a number of recommendations on financing: finance it ourselves on our statement would probably be the [203] least expensive way to do it; to create a real estate holding company off our statement, finance it on that basis; to just find an investor and let him build the building and we just be a tenant in the building and let him speculate on the rest of the building; sale and leaseback was another manner that they pro-

posed that we consider. There may have been another. There was a section in there on recommendations.

Q. At the time they recommended the acquisition of that site who owned that site or was it in the process of being acquired? A. The Little Rock Housing Authority was in the process of acquiring it. I don't know whether they owned the full site yet. There were 17 or 18 different parcels in that block. It was part of the down town urban renewal project and was being acquired by the Housing Authority.

Q. And would you just briefly explain what you had to go through with in order to bid for and be awarded that site. A. Well, the bid was not just on a price basis. They had a public ad. Anybody interested in making proposals on this site could make submission to the Little Rock Housing Authority.

The bid was not just solely on price. You might be the highest bidder pricewise, but if you were not going to develop the property in keeping with the redevelopment of the down town area, you would probably not be a successful bidder.

[204] Our bid did include and was required by law to include not only the price but also schematics, outlines, layouts, of what we planned to do with the site.

Q. And this was in 1965 and 1966—— A. '66.

Q. —that you were negotiating for this site.

When did you begin to make contacts with lendors and investors to discuss the financing of the business and who were some of the earlier people you went to in that connection? A. Well, along about the same time that we were studying proposals and making proposals to the Housing Authority, we also had committees working on the design of the building, our needs within our own organization, what we could project, the size of the building we would need over the next 25 years; another group working on how we were going to finance this project. These contacts were going on simultaneously in 1966.

Q. Do you remember the names of some of the people that you contacted? A. Either I contacted or representatives of the bank contacted—I didn't contact all these people personally—but the Bank Building Corporation of St. Louis who had originally built our building in 1929. We talked with them at length and received a proposal from them.

We talked with the Chase Manhattan Bank; White, Weld which is an investment banking firm in New York; talked with [205] Brooks, Harvey, Smith, Barney; Eastman Dillon; others. There is a number of others. We talked with the National City Bank of New York, real estate section.

Q. What about Solomon Brothers and Holtzen? A. Solomon Brothers and Holtzen and something Westerveldt.

Q. Hubbard Westervelt and Mottelay? A. Hubbard Westervelt.

Q. What about J. Halperin and Company? A. Yes, sir, we talked with them. We talked with about anybody that would talk to us about financing the building, anybody that had any experience in that area. We talked to almost all those people and received proposals from most all of them.

Q. By way of background would you also state what was happening, insofar as your chief competitor is concerned, with its building plans? A. Well, the Union National Bank had acquired an urban renewal site in the down town area and were in the process of putting together a building program. They were probably six months ahead of us in their planning for the type of building they were projecting to build, and there was some anxiety about who would be completely first so they would be able to attract tenants into the new office building.

Q. What happened with reference—you say they were about six months ahead of you in timing. Were you able to catch [206] up with them and how or what happened that enabled you to catch up? A. There was civic project developed that was called Capitol Place, the idea being—and I don't know where it originated—but to build an under-

ground parking in the center of the downtown area to hold about 2200 cars.

Mr. Louis Rosen was one of the principal motivators behind it. It would be under the plot where we were going to build, under the street, under the plot where the Union National Bank was going to build and under the plot where the old Franke's Cafeteria used to be. It would tie in underground to the major department stores and back into Main Street. We would anchor the downtown center of Little Rock around this 2200 car parking garage.

In order to give that time to develop, the Union National Bank and our bank agreed not to go forward with the groundbreaking and actual construction on our building until Capitol Place had had an opportunity to run its full length. That span of time gave us a chance to get our banking caught up to where we were pretty well ready to go when Capitol Place was not able to come into fruition.

Q. That project fell through sometime in the summer of 1967, I believe. A. Yes.

Q. And at that time had you completed all of your plans [207] with reference to the building? A. No. We were under a new theory of building. Rather than complete all the detailed plans and specifications, we were building under a theory of building against a budget. The architect and the engineers and contractors were just staying ahead of the actual building of the building.

Again, I mentioned we had been very close to the First National Bank of Memphis and we visited with them. They had just abo t two years before completed their building.

We counseled with them and got their help and advice and this is the way they had built their building. They had been able to speed up the construction considerably because they did not have to have a fixed price and bid. They did not have to have all the detailed architectural plans and specifications completed before building was started.

Q. One other problem with reference to delay and finally acquiring the building site. Was there any problem with reference to an alley which resulted in delay? A. We submitted our bid and the Housing Authority represented to us that the alley running north and south through the center of the block would be closed. We could so design our building around it.

When the Housing Authority attempted to close the alley, one of the joining tenants objected and said he would go all the way to the Supreme Court of the United States before he [208] would see the alley closed, which we anticipated would take at lease two years. So we negotiated with him and agreed to open the alley into Center Street. Now the alley that runs east and west from Center Street into the old north-south alley is a public dedicated easement even though it fits into the overall plan of our building. That's how we were able to negotiate that with our neighbor tenant.

Q. Do you remember when that problem was cleared up and you were able to acquire the site? A. It would be in the summer of 1967 since we started construction in August of '67.

Q. Did you start construction in August? A. July.

Q. Do you remember the date of closing of the site? Does September 15 ring a bell? A. Yes. Because we tried to get the Housing Authority to let us not pay for the land. We tried to lease the land on a long-term lease. They did have a program [sense?] could lease, under certain circumstances, land on a long-term lease. We tried that and that didn't work.

Q. It's a fact that the purchase of the site was closed on September 15, 1967? A. Yeah, I believe that's right.

Q. Is it also a fact that construction began on September 15, 1967, the very day you closed? [209] A. Yes.

Q. At that time had you completed arrangement in connection with the financing of the building? A. No, we had not.

Q. Why, then, did you proceed to begin the construction as soon as you acquired the site even though you had not completed the financing arrangements? Did this have anything to do with Union National Bank? A. Again, we were anxious to have our building completed as quickly as possible because we were building a building which we were only going to occupy about a third of it.

We felt a very strong responsibility to have tenants in it as quickly as possible. The Tower Building's tenants were coming up on their first 10-year renewals and they were the prime target. We knew the Union National Bank was working very hard on them and representing a much earlier occupancy date than we could. So we felt it extremely important to us to get started, plus we were coming up out of the hole in the ground before the winter was on us.

Q. I believe you have stated that you made contacts with a lot of investors and lending agencies. Who else in the bank did a lot of the contact with potential investors or lendors and worked on financing plans? A. Dick Gates, who was a vice-president in charge of [210] our investment division, was in charge of the finance committee charged with lining up the financing: how we were going to finance this building. Dick had that responsibility. He did a major portion of the day-to-day work on this project.

Q. Is he still with Worthen Bank A. No, Dick is retired and lives right out of Tampa, Florida now.

Q. In connection with proposals that you received from a large number of potential investors or lendors, what were the basic types of proposals they made? A. Well, we received proposals for joint ventures where we would go in with some major owner and they would own a part of it and we would own a part of it similar to what the First National Bank of Little Rock has done with two other investors.

We received proposals from companies where they would build the building and lease us the space we needed and they would take the risk of leasing the rest of it and we could draw plans and specifications and we could build the type of building we wanted to build. We were very conscious of the fact we wanted a prestige building and wanted it to be a building that was not just in circulation as a regular office building but one that would stand for many years and be symbolic of the type of organization we try to portray. We received all kinds.

Q. Were there any suggestions that Worthen own the property and finance it through any conventional mortgage loans [211] or any assortment of capitol notes or debentures? A. That's what we wanted to do. First, we wanted to carry it on our books. We determined that was not possible or doable because of the regulatory authorities' limitation as to the amount of capitol you could carry on your books.

That would have been the least expensive way for us to do it because our cost of funds is less than what we could go into the market and borrow it. That was the most advantageous way for us to finance the building.

The regulations—and we were a state bank at that time. We have since converted to a national bank. The regulations of the State Bank Commissioner and the Federal Reserve who were the two supervisory agencies, would not permit you to put more than the amount of your capitol stock or 40 percent of your capitol and surplus, whichever is less, in real estate. We couldn't come under those regulations.

We elected next to organize a real estate holding company for the bank to sell debentures to the public in the amount of $4 million to buy the land and then to lend to the real estate holding company the $4 million, and the real estate holding company use that as equity to borrow the additional money—we thought it would take about $9

million total—borrow the additional money on a conventional real estate loan to finance the building.

That way it would be off our balance sheet. We thought [212] it would not be charged against our capital account and we proceeded to develop that idea.

Q. Before we go on with that idea, on the acquisition of the site did you obtain the approval on the acquisition of the site—— A. Yes.

Q. —from any of the bank regulatory authorities? A. Yes, from the State Bank Commissioner, who was the primary regulatory authority.

Q. And also did you obtain the authority—did you have to take this before the Federal Reserve Bank of St. Louis? A. Yes.

Q. Would you explain a little more in detail why you were governed by two regulatory authorities: both the State Bank Commissioner and the Federal Reserve Bank of St. Louis. A. As a state bank we were not required to go on to the Federal Reserve System. It was optional on our part. Being in a reserve city such as Little Rock, being very active in the correspondent bank business—we had been a member of the Federal Reserve for many, many years—we had a dual supervision. Our primary supervisor was the State Bank Commissioner. However, we had to comply with both regulations. We were examined by both groups. We must comply with both their supervisory directives and we had a dual—we had two bosses.

Q. I believe, Mr. Penick, I won't take time to read it [213] but will simply call your attention to the fact that Plaintiff's Exhibit 37 contains the consent of the Federal Reserve Bank of St. Louis to the acquisition of the site. That's a letter dated August 22, 1967. A. Yes, sir.

Q. Now getting back to your first proposal or first plan to have a wholly-owned subsidiary own the building, Worthen would sell $4 million in debentures, invest the money, use that money to buy capitol stock of the wholly-owned subsidiary; and then the wholly-owned subsidiary would

finance the balance of the construction—estimated construction cost of $9 million how? Through a conventional mortgage? A. Through a conventional mortgage loan.

Q. Was that plan spelled out to both regulatory authorities? A. Yes, sir.

Q. I believe you introduced into evidence—we have Plaintiff's Exhibit No. 1, which is a letter to Mr. O. O. Wyrick dated August 26, 1967, which spells that plan out, does it not? A. Yes, sir.

Q. And you are requesting their approval of that plan? A. Yes, sir.

Q. I believe that letter concludes: "We expect to begin construction as soon as we have received approval and your early consideration is appreciated."

[214] Was almost an identical letter written to the State banking authority? A. Yes, sir.

Q. I believe you will find that on—well, I don't believe we introduced that as an exhibit, but almost an identical—

It's mentioned in the letter that as soon as we received approval of the State Bank Commissionertheir actions are not contingent upon each other. They could act independently. The State Bank Commissioner could approve it at the same time the Federal Reserve in St. Louis was considering it. We didn't have to get one's approval prior to submitting it.

Q. So you submitted it—about the same date you wrote to Mr. Wyrick in the Federal Reserve Bank you wrote a similar letter to Mr. Adams? A. Yes, sir.

Q. Then what happened with reference to that first proposal? A. I got a telephone call from Mr. Wyrick calling attention to the fact that if the real estate company was a wholly-owned subsidiary of the bank, that the investment in the real estate company would be charged the same as if there was an investment on the bank's books. Consequently, that was not doable under those circumstances.

Q. That applied not only to the investment of Worthen in the stock of the wholly-owned subsidiary but any indebt-

edness [215] of the wholly-owned subsidiary to acquire the building would also be counted the same as if it was invested by Worthen on its own books in banks premises; is that correct? A. Yes.

Q. And if it exceeded the $4 million, what would be required? A. Well, we could have exceeded the $4 million but in order to do so you must get the Federal Reserve in Washington approval. The local Federal Reserve Board, the St. Louis Federal Reserve Board, the Eighth District did not have the authority. You had to go all the way to the Federal Reserve Board in Washington, D.C. They did not have authority to waive that requirement.

Q. Did you talk to Mr. Wyrick about waiving the requirement? A. Yes, I talked to him about the probability: did he think the Federal Reserve Board in Washington would be acceptable to our proposal and would they waive it.

Q. Incidentally, does the Federal Reserve Board in St. Louis have to make any recommendations with reference to waivers that go to Washington? A. He makes a recommendation to the Board in St. Louis—Mr. Wyrick does—and they in turn make a recommendation.

Q. What did he tell you their recommendation would be? A. He said he could not recommend it. He didn't say he [216]—he would recommend against it; he just said: "I cannot recommend it."

Q. Did you also have any discussion with a Mr. Britton Leavitt in Washington on this subject? Who was Mr. Leavitt? A. Mr. Leavitt at that time was the chief examiner for the Federal Reserve System. I did not see him in Washington. I talked to him at a banking meeting somewhere and visited with him about our proposition and just asked him what he thought the Board's reaction would be. And he also affirmed that if it were put to him, he would not recommend it.

Q. And why would they not recommend it? What was the problem with Worthen with reference to capitol ade-

quacy? A. We had experienced excellent growth through the years, over 15 percent compounded annually. The supervisory authorities require that you maintain a certain relationship between your capitol and your deposits. At each examination they had admonished us that our capitol ratios were not too strong.

We had been putting in anywhere from a million to a million and a half dollars new capitol. We had been restricting our dividend payout to less than 20 percent of our operating earnings for a number of years, and we had still not been able to put the capitol into the bank to support the growth that we had had in the last 15 years.

Q. Now with reference to your first proposal—that is, the sale of debentures—was there any objection to that proposal [217] from the state banking authority and if so, what was it? A. No. He didn't object to that. He said he would approve it conditioned on us having the right to repurchase the building at the end of 15 years.

Q. Was there also any problem with reference to any statutory limit on the amount of interest you could pay on the debentures? A. He called to our attention the fact we could only pay six percent under Arkansas law on debentures at that time.

Q. And what was the possibility—did you make any inquiry as to whether or not you could sell the debentures at six? A. We thought we could until we went to New York to try to sell them, and we came back and were told there was not any way we could sell them at six percent.

The market was at least one percent above that for banks our size and in our situation, and there wouldn't be any way we could sell the required number of debentures, $4 million in debentures, to fund this project on the basis on which we had anticipated doing it.

Q. So for both of those reasons what happened with reference to the first plan? Did you just abandon it? A. We just dropped it.

Q. And then proceded at once to submit—work out a second plan; is that correct? [218] A. Yes.

Q. Would you refer to Plaintiff's Exhibit No. 5 and just briefly summarize. Does that set out the second plan—proposed plan of financing? A. Yes. This sets out the plan of working out a sale and leaseback and in this letter mentions and that's the company we were in the most serious negotiations with at that time, outlining that we would hold on our books the maximum amount we could under the law because, again, that was the least expensive way for us to finance this building. Our cost of funds at that time was less than five percent.

So we wanted to hold the land and as much of any divisible or identifiable building we could. It turned out the way the building was drawn that the parking facility was as separate and as identifiable as we could get.

We planned to hold the land and the parking facility on our books: work out a sale and leaseback for the remainder of the building.

Q. And I believe that letter states near the top of page two that you would have the right to repurchase this building after 15 years at a previously agreed upon figure and the land at cost. A. Yes, sir.

Q. I believe you have already stated Mr. Adams had verbally told you prior to this letter that this would have to be [219] a requirement. A. The sale and leaseback, yes.

Q. They are the ones who proposed the fifteen year—option to purchase after 15 years? A. In conversations and when he later came back he put that in his letter.

Q. The second paragraph on page two reads: "We realize that the sale and leaseback arrangement may be slightly more expensive in the long run. However, we are of the opinion that the advantages it offers us are not tying down our capitol in land and building leaves us more lee-

way in the management of our bank and keeping our funds more profitably employed."

Would you expand on that just a little bit, Mr. Penick? Explain what you were driving at there. A. Well, as I mentioned, our cost of funds was about five percent. We realized we were going to have to pay more than that on whatever we could negotiate the best deal on the real estate loan on the sale and leaseback. Also, in order to maintain the proper ratios between capitol and deposits and capitol and loans, capitol and the amount invested in the real estate, that we felt like we could utilize the capitol we had in the bank rather than go out and try to acquire additional capitol.

We had gone back to our stockholders for a number of times, almost each year, for a million or a million and a half [220] dollars, and we didn't think we could continue to go back to them. So we wanted to finance this off our balance sheets.

The capitol we had would allow us to grow about, oh, $10, in deposits for each dollar of capitol. If we obligated that capitol on real estate, would compound our overall capitol problems.

Q. So by having less money invested in real estate, it would—for each dollar invested in capitol that's free, liquid capitol, that generates about how many dollars for lending purposes? Through increased deposits it allows you to— A. Well, that's economic theory. I have heard anywhere from six up to fifteen, but I would say you can go into the neighborhood of—

Q. But by keeping your capitol in a liquid position it did improve the profitability of the bank because you could better employ the capitol in the normal operation of the business: isn't that true? A. That's right, and to support our growth at that time and the anticipated growth we were looking forward to.

Q. What about the liquidity situation? How did the sale leaseback improve your liquidity problem? A. For each dollar of fixed assets in computing your liquidity they charge you $1 against your capitol, so it is very difficult in a growing bank to have enough capitol in it. [221] Once you've got the capitol in and have it maintained, it's a lot better to finance real esta'e projects such as this off your balance sheet.

Q. And are there certain regulatory authorities that require the bank to maintain a certain liquidity position? A. Yes, sir.

Q. And are there certain required capitol ratios that are affected by whether or not the building was financed on the bank's statement or off the bank's statement? A. As I mentioned, the capitol you have invested in the real estate for each dollar you invest in real estate you have to have a dollar capitol to support it. It's considered as a non-liquid asset and the last thing you can dispose of in computing a liquidity formula.

Q. Now I refer you to PX-2, Plaintiff's Exhibit No. 2. The one we have just been referring to was the letter you wrote to Mr. Adams dated September 1st.

Did you also write a letter containing the same plan to Mr. Wyrick, Plaintiff's Exhibit No. 2 also on September 1st? Will you refer to that? A. Yes, sir.

Q. I believe you outlined the plan by simply enclosing a copy of your letter to Mr. Wyrick and you pointed out you were presently negotiating with Goldman and Sachs to handle the sale and leaseback and enclosed some leasing brochures and [222] excerpts from the Landauer report. Then you asked him for his approval of this plan; is that correct? A. Yes, sir.

Q. And in response to that would you refer to Plaintiff's Exhibit 6 which, first, is the response from Mr. Adams. Again, would you briefly summarize that? A. Did you say Exhibit 6?

Q. Yes, Exhibit 6. A. Okay.

This is a letter from Mr. Harvill Adams, State Bank Commissioner, in response to my previous letter of September 21st in which he approves of the plan as outlined to finance as much of the building as we could on our statement and the balance on a sale and leaseback arrangement.

Q. And then on the sale and leaseback arrangement, referring to the last sentence, does he again repeat his requirement that you have an option to repurchase after 15 years? A. Yes. Quoting from his letter: "It is agreeable with this department with the understanding that you would have the right to repurchase this building after 15 years at agreed upon figure and the land at the cost at which it was, not to exceed, $965,000."

Q. Now, Mr. Penick, I would ask you, please, to refer next to Plaintiff's Exhibit No. 38 which, I believe, was your initial response from Mr. Wyrick to this second proposal. Would [223] you briefly summarize what he is requiring? First, I would ask you: Is this a memorandum of a telephone conversation you received—I mean you had with Mr. Wyrick on September 6, 1967? A. Yes.

Q. And you wrote this immediately following that telephone call? A. Yes, sir.

Q. Would you briefly state what it is that is worrying Mr. Wyrick with reference to this second proposal? A. The point he wanted to emphasize to me was that if it were going to be a clear sale and leaseback—in other words, if Goldman and Sachs, or other investors, were going to build the building and lease it to us, that he wouldn't have any hesitancy in approving that.

However, if we were going to borrow the seven and a half million dollars or to finance in any way the interim construction funds to any builder, that it could not be approved because it would run us over the $4 million we were allowed to put into the building without going to the Board of Governors. He just wanted to let me know that

even if we went through a third person—if we loaned the money on the interim construction or in any way put our money into it that went over the $4 million, we would have to go to the Board for approval.

Q. Now I will ask you to refer to Plaintiff's Exhibit No. 7, which is a letter to Mr. Adams, and state what it—[224] incidentally, did Mr. Wyrick also raise any question as to the handling of an allocation of architect fees and finance charges as consultant fees as between the Worthen Building and the garage? A. Yes. He wanted to be sure that we set that up separately on our books so we could account for what portion of it was chargeable to a part of the building Worthen was going to keep, what portion would be chargeable to the building that was going to be purchased by the investor.

Q. And would you just briefly summarize your letter to Mr. Adams dated September 12th? A. Again, it's the position we were in between two regulatory authorities trying to keep both informed as to what the other was doing. I don't know whether they were talking to one another.

But to inform Mr. Adams we had to revise the figures I previously furnished him as to architect fees, consultant fees, and others as directed by Mr. Wyrick since none of this would be allowed to be carried on our books. Just to keep Mr. Adams informed.

Q. Refer to Plaintiff's Exhibit 8 and state what Mr. Adams responded. A. He said: "I have your letter of September 12th in which you request several changes be made in the project cost of the parking garage, furniture and fixtures, and leasehold [225] improvements.

I have no objection to these changes and you are authorized to procede in accordance with your total project cost as presented to me in your letter of September 12."

Q. Now referring back to Plaintiff's Exhibit 3 which begins: "In line with our conversation . . ." this is a letter

to Mr. Wyrick following your conversation with him. You are explaining, first, that you will allocate the fees as he has requested; and, second, that in the second paragraph you will convey title to the land in which the bank office and building will be built to investors so that they will own the building and go on to state it won't at any time appear on your books.

Then refer to Plaintiff's Exhibit 4, which is a letter from Mr. Wyrick to you dated September 13 having received from you your letter of the 12th.

Would you just briefly—well, read the second and third paragraphs.

The Court: I will read those.

The Witness: He just summarizes that original proposal we had made to Mr. Adams with the admonition, again, that if we went over the $4 million we'd have to get approval of the Federal Reserve Board for any amount, whether it be interim financing to a third party investor in any way.

Q. Refer again to the last sentence and state if this is the type of admonition you had been receiving from regulatory [226] authorities for quite some time? A. He admonished us that the capitol account was not relatively strong and the directors are urged to review the bank's capitol position frequently.

The Court: All right. Mr. Williamson, I think we have gotten as much out of this day as we can. I know we have gotten more out of our reporter than we are entitled to. We are going to recess.

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[229] DIRECT EXAMINATION—Resumed

By Mr. Williamson:

Q. Mr. Penick, I believe your testimony closed yesterday at a point in which you had brought out that both Mr. Adams of the State Banking Department and Mr. Wyrick of the Federal Reserve in St. Louis had approved the second proposal of Worthen Bank involving the sale-leaseback arrangement for the purpose of providing the building. A. Yes sir.

Q. Following that approval, did you at first continue to negotiate with Goldman Sachs insofar as the sale-leaseback arrangement is concerned? A. We continued to negotiate with Goldman Sachs and a number of others including Stephens, Incorporated and Eastman Dillion; White, Weld.

Q. And would you state whether or not your negotiations with Goldman Sachs resulted in a tentative proposal from him? A. Yes.

Q. Would you refer to Plaintiff's Exhibit No. 9 and [230] state whether or not that is the proposal from Goldman Sachs—tentative proposal from Goldman Sachs?

Q. Then I believe you also just testified that you negotiated with—began negotiations with Eastman Dillion. Did they come up with a tentative—would you refer to Plaintiff's Exhibit 39. A. Yes, they came up with a tentative proposal.

Q. And that is a letter dated September 20, '67 to you from Eastman Dillion? A. Yes, sir.

Q. And that was their first proposal; is that correct? A. Yes.

Q. Then refer to Plaintiff's Exhibit No. 10. Now first the question: Was Eastman Dillion working in consort with any local investor? A. Not originally. They did later join with Stephens, Incorporated in a joint proposal. Initially, they were not.

Q. But even as of the date—if you will refer back to PX 39—even as of the date of September 20, they had associated Stephens, Inc. with them, had they not? A. Yes.

Q. Look at the first part of that. A. Yes, they had, but our initial contact with them, they did not involve Stephens.

Q. Referring to Plaintiff's Exhibit No. 10, did Eastman Dillion and Stephens, Inc. submit a revised proposal? [231] A. Yes, they did.

Q. And that was dated what date? A. October 27, '67.

Q. So at that time you had under active consideration proposals by both Goldman Sachs, Inc. and Eastern Dillion, Stephens, Inc. combined? A. Yes.

Q. Would you please state to the Court just how Frank Lyon Company became involved in these negotiations as you remember it? A. Frank Lyon Company came in very late. We were just about finalized down to one or the other of these two proposals. Mr. Lyon, who serves on Worthen Board, called me and asked did I have any objection or did he think it would be proper for him to make a proposal. He had not been familiar with the proposals of other companies since he was not—this negotiation was being handled by a finance committee for the building and Mr. Lyon was not familiar with that.

Q. He was not a member of that committee? A. He was not a member of that committee. I told him I thought it would be perfectly acceptable to me and I thought to the Board of Directors for him to submit a proposal and encouraged him to do so.

Q. So that we won't have to repeat the evidence that's [232] already been introduced, Plaintiff's Exhibit, PX 11, would you refer to that? That is the first proposal that Frank Lyon Company submitted to you? A. Yes.

Q. On the receipt would you refer to Plaintiff's Exhibit, PX 12? At that point then you had on the receipt of Frank Lyon's bid you had bids from Goldman Sachs, and Frank Lyon Company. What did you proceed to do with those three proposals? A. I didn't personally, but the finance committee chaired by Mr. Gates put the three proposals

side by each and compared the best part of each proposal to the best part of each other proposal. We then—some were better in some areas and other proposals were better in other areas, and we decided to pick the best part of each proposal and submit back to these three what we would like to have and say, "If you will meet these specifications we will go with you on it." So that was the basis on which our specifications were written because we picked the best of each of the three proposals.

Q. And those specifications are set forth in Plaintiff's Exhibit 12? A. Yes, sir.

Q. Before you leave Plaintiff's Exhibit 12——

The Court: I see. Yes. All right.

By Mr. Williamson:

[233] Q. Referring back to Plaintiff's Exhibit 12, you will note in the last line of the comparison or the last three lines, you compare the totals as of the end of the 15th year. Would you explain why you used the end of the 15th year in order to work out a comparison, taking into consideration the repurchase options and so forth. A. The State Bank Commissioner had required that we have the right to repurchase the building at the end of 15 years and that was in our requirement.

Q. And looking up there at the three on the repurchase options, the years available at which repurchases were included in the three proposals you then had to date, is it true that the 15th year is the only year in common—— A. That's right.

Q. —on which all three of them had an option to repurchase? A. Yes, sir.

Q. And consequently would you state whether or not that is the only year in which you could make a comparison of the three bids? A. Yes, that's right. That was the only year in which we did have figures on the repurchase from all three bidders.

Q. Then I believe there's been some testimony from Mr. Cotham yesterday that you had suggested to Frank Lyon Company that they consider submitting a joint bid with Stephens, [234] Inc. Would you state a little more in detail as to why you made that suggestion and did you make the same suggestion to Stevens? A. As I mentioned, we were pretty far down the road in our negotiations with Stevens that had been joined by Eastman Dillon and by Goldman Sachs, and we were about ready to try to resolve between these two when the Frank Lyon Company became interested in the proposal. Stevens, Incorporated is a good customer of the bank. Jack Stevens, the president of the firm, is a personal friend, and we wanted to retain the business of both Stevens and also the Frank Lyon Company.

Mr. Lyon is in the same position: a good customer of the bank, a director and a friend. It is my responsibility and our responsibility, however, to get the best deal for the bank regardless of that and we were trying to do a little public relations work and get those two to join together and each take a part of this deal.

Q. Did you also suggest to Stevens that they consider a joint bid? A. Yes, sir.

Q. Would you state to the Court what the reaction of both parties was? A. The reaction of both parties was, "We don't need the other." Evidently, it was not such an attractive deal that [235] split down the middle it would have been attractive to either party. Half of it wasn't big enough for Stephens and, evidently, half of it was not attractive to the Frank Lyon Company. Neither one felt like it would be to their advantage to join with the other.

Q. So what happened then when you submitted the specifications for sale and leaseback to Stephens and Frank Lyon Company? A. And also Goldman Sachs. Goldman came back in a telephone conversation and said they had made their best proposal to us. Stephens, Incorporated came back and said they couldn't—weren't interested in

changing their previous proposal and wouldn't meet the specifications that we had set out in our agreement. And Frank Lyon Company came back with a letter that said they would meet it and reduce the rent $21,000.00 a year.

Q. Now while we are on the $21,000.00 a year, would you proceed to explain—now that was a proposal November 1 of 1967, was it not? A. Yes.

Q. The bank building—and it was based on this proposal that the parties proceeded to negotiate for some six months before coming up with the final document which the evidence has shown were executed about mid-May of 1968.

When was the bank building completed and first [236] occupied? A. About December of 1969.

Q. So the question of the payment of the reduction of the rent by $21,000.00 did not become a material factor until the rent began; is that true? A. That's right.

Q. In the meantime, was any proposal made in connection with the building lease to fix a rent at $21,000.00 less than the amount required to amortize the note? A. That was in the original proposal when——

Q. What was the reaction of New York Life to that? A. New York Life would not accept it. They would not accept any less payment less than that necessary to amortize their loan.

Q. And those documents were executed in May of 1968 I believe. A. Yes, sir.

Q. And nothing more was said about the $21,000.00 until what happened? A. No, at the time that we were not able to handle it as a reduction of the lease it was acknowledged by the Frank Lyon Company as an obligation to Worthen Bank to be repaid over a five year period in some form or fashion, but originally structured as a rental reduction. When that was not allowed, it was still acknowledged as an obligation from [237] Frank Lyon Company to Worthen Bank.

Q. Then would you follow on through as to what happened with reference to the $21,000.00? A. Well, in August when the Frank Lyon Company borrowed the $500,000.00 to make the down payment on the Coca Cola Company, I believe it was Dick Gates that came up with the idea of charging Frank Lyon Company a rate of interest over and above what the prime rate at which they borrowed sufficient for us to gain the $21,000.00 the Frank Lyon Company would owe us for the first year of the five year period.

Q. Do you remember what the rate of interest was? A. No, I don't. I think it was nine and a half percent.

Mr. Williamson: Your Honor, somewhere here I have a copy of the bank's ledger reflecting the loan and reflects the rate to be nine and a half. I'd like him to be certain on that. I will move on to another point.

The Court: Very well.

By Mr. Williamson:

Q. What has happened in the meantime, Mr. Penick, to interest rates? A. They have gone up to a prime rate of 12 percent.

Q. At the time the Coca Cola loan was made, you were loaning money to Frank Lyon normally at what rate then? [238] A. At the prime rate, it was probably six or six and a half.

Q. Has the $21,000.00 obligation which converted into five year reduction of rent would be a hundred and five thousand dollars, has that been completely discharged to date? A. No. Only less than a fifth of it.

Q. Does Worthen Bank still consider this an obligation of Frank Lyon? A. Frank Lyon Company, yes, sir.

Q. And will you see that its is paid? A. Yes, sir.

Q. In some form or other? A. Yes, sir.

Q. To refresh your memory on the rate of interest that was charged on the Coca Cola loan, I believe this is the $500,000.00. A. This is the date of the note.

Q. Well, I thought I had—here it is.

On August 21 this is the first entry on the $500,000.00. A. Yes, sir.

Q. This is a copy of your ledger on Frank Lyon—Worthen Bank ledger on Frank Lyon Company? A. Yes, sir.

Q. What was the rate of interest that was charged on [239] that $500,000.00 note dated August 21, '69? A. Nine and a half percent.

Q. Just glancing at this ledger since we have it, what was the balance, total liability, of Frank Lyon Company to Worthen Bank—well, at any date throughout '69? That liability was running about what? A. Over $2 million. On August the 20th of 1969, was $2,023,078.44. That was transferred to this sheet.

Q. Pick another date as of the end of '69, what was the amount owed Worthen Bank? A. A million four hundred fifteen thousand five seventy-eight on October 6 of '69. January the fifth of '70 would be as close to the end of '69 is a million four hundred three thousand seventy-eight and forty-four cents.

Q. Take the last one on the page. January 6, 1971, how much was owed? A. A million two hundred seventy-five thousand.

Q. All the way through, Frank Lyon owes considerably in excess of a million dollars, do they not? A. Yes, sir.

Q. I believe it's already been brought out that tentative commitments had been made by First National City Bank and by New York Life Insurance Company for interim financing and permanent financing to an investor; is this true? [240] A. Yes, sir.

Q. And can you state who had made those tentative arrangements? A. Well, it was only natural for us to make those arrangements ourselves. The First National City Bank of New York is our principal—or was at that time our principal New York correspondent bank. We were

in daily contact with the principal officers of that bank. We were talking about borrowing $7.5 million. That would be the natural place that we would go.

We were also—my father was a long time personal friend of Mr. Dudley Dowell, who was the president of New York Life. We had done a number of other financing projects for New York Life in Arkansas. It was only natural that we would go to New York Life Insurance Company to talk with them about the mortgage on our building.

And on the trip to New York, we made the contact with Mr. Dowell and he brought in real estate people and also with the top people in the First National City Bank, at which time we got variabble commitments on both the interim financing at the National City Bank of New York prime rate which was a real concession to us.

I don't think any other borrower just walking in off the street would have gotten prime rate loan on an interim construction project. Then we got a verbal commitment from [241] the New York Life Insurance Company for a permanent loan subject to an acceptable investor to them being submitted which would have to be substantiated on its books.

Q. So would you state whether or not it was to Worthen Bank's advantage using your own connections to arrange for interim and permanent financing? A. It was to our advantage from the interest rate standpoint to arrange that. It was to our advantage to use our contacts so we could keep to a minimum the fees and other costs that are normally incidental to this type of financing. We realized in the long run we were going to have to pay for it one way or the other, so we wanted to keep our cost down to a minimum.

Q. And you would have to pay for it through it in the form of rents—— A. Yes.

Q. —That would be required to amortize the loan; is that correct? A. Yes.

Q. Would you refer to Plaintiff's Exhibit No. 16. This appears to be the commitment letter from First National City Bank addressed to Edward M. Penick, obligating First National City Bank to make an interim loan of $7 million to "a mutually acceptable real estate corporation."

This is the written commitment of First National City Bank for the interim financing? [242] A. Yes, sir.

Q. And I believe from Plaintiff's Exhibit No. 17 that commitment letter was, in fact, addressed to Frank Lyon Company, the commitment letter on the permanent loan from New York Life. A. Yes.

Q. Mr. Penick, were you in the courtroom yesterday and heard testimony of Ralph Cotham with reference to the extended—and Mr. Darrell Dover with reference to the extended negotiations to work out all of the documents involved in this transaction? A. Yes, sir.

Q. You were aware, were you not, these were going on? A. Yes, sir.

Q. Did you participate in any of the discussions? A. In some of them, but not on a day-to-day basis.

Q. Only those that involved some final decision on the part of the bank? A. Yes.

Q. Did you participate in those? A. Yes.

Q. Would you state whether or not the documents were, in your opinion, the result of arms-length negotiations and bargaining? A. Yes, they were. Very tough bargaining on the part [243] of all parties involved in it.

Q. After the documents were worked out and about in final form, was there any requirement from New York Life that the form of the transaction in its final form be resubmitted to the bank regulatory authorities for their approval? A. They required that after everything was agreed on before any money was disbursed that they finally approve the actual document.

Q. Would you refer to Plaintiff's Exhibit No. 40 and describe briefly what that it? A. This is a letter from me

to Mr. H. C. Adams, State Bank Commissioner of the State of Arkansas, regarding the construction of the Worthen Bank Building.

Q. Would you read just the first paragraph of it? A. "I have previously discussed with you and you have previously indicated your approval of the sale and leaseback arrangement for the financing of our new bank building. However, attorneys for New York Life Insurance Company, the permanent lender, and the First National City Bank of New York, the construction lender, have requested that Worthen Bank and Trust Company obtain formal approval by the State Bank Commissioner of the consummation of the transaction involved in the construction of our new bank and office building."

Q. And then follows three pages describing in detail exactly what is going to be involved in the transaction; is [244] that correct? A. Yes, sir.

Q. And then the final paragraph on page four, "You are requesting"—would you just read that? A. "Since your approval of the foregoing is being required by First National City Bank to close the construction loan, we would greatly appreciate hearing from you at your earliest convenience."

Q. Then refer to Plaintiff's Exhibit 41. A. "By way of interest he endorses on the letter, "The plan of financing your building as outlined in this letter has been approved." Signed by Mr. Adams.

Q. Right.

Then refer, please, to Plaintiff's Exhibit 41, which appears to be the identical letter you wrote to Mr. Adams which was addressed to Mr. Wyrick; was that true? A. Yes, sir.

Q. Also referring to the last page of that letter, Mr. Wyrick expressed his approval on what date? A. April 23, 1968.

Q. However, before doing so, was there some further correspondence with Mr. Wyrick? Refer first to Plaintiff's

Exhibit 42. I call your attention to the fact that your letter to Mr. Wyrick was dated April 16.

On April 19 he wrote you a letter raising what [245] questions with reference to the transaction? Would you just read that letter? A. This is a letter from Mr. O. O. Wyrick, vice-president of the Federal Reserve Bank of St. Louis addressed to me.

"This refers to your letter of April 16, 1968, regarding interim and permanent financing for the new bank building under construction and requesting our approval of the program outlined in your letter.

"On the basis of previous understandings that the bank's investment in bank premises will not exceed its capital stock, my letter of September 13, 1967, advised that the proposed new building project would not require prior approval under the provisions of Section 24A of the Federal Reserve Act of the Board of Governors of the Federal Reserve System. At that time it was understood that the bank would have no financial interest in the building and would furnish none of the funds for its construction.

"Your letter of April 16, 1968, indicates that Frank Lyon Company shall arrange for the construction loan. In order that we may be in a position to execute the approval requested in your letter, the following information is required:

"Number one, please advise us as to the present carrying or book value of all bank premises, all offces, including leasehold improvements.

"Number two, caption or title and present balance in 'construction account'.

[246] "Number three, a projection as to the highest amount construction account will reach before the bank is reimbursed by the Frank Lyon Company.

"Four, your assurance of that the book value of the bank premises plus the balance at any time in the construction account will not exceed the bank's capital stock.

"Upon the receipt of this information and assurances we will be in a position to act upon your request."

Q. Following that letter—referring now to Plaintiff's Exhibit 43—what was Worthen Bank's response? You don't have to read it if you are familiar with the contents. You can just paraphrase it, saving time. A. I assured him we would not at any time have more than $4 million carried on our books in the construction account; that the Frank Lyon Company would purchase the building as it was being built and we would not build the building and sell it to Frank Lyon Company after completion.

Q. Then following receipt of that letter—referring to Plaintiff's Exhibit 44—what was Mr. Wyrick's response? A. He granted his approval to the financing plan we had outlined in our previous letter of April 19.

Q. And it was with this letter of April 23 that he returned to you your original letter to him dated April 16—— A. Yes.

Q. —the last page of which he executed his agreement [247] of the financing plan; is that correct? A. Yes, it is.

The Court: His requirement then, I gather, was the basis for the decision to transfer, in effect, the title on a brick-by-brick basis during the course of the construction to keep the total not to exceed the limitation of $4 million?

The Witness: Yes, sir.

By Mr. Williamson:

Q. And had he made that quite clear to you even preceding October? A. In telephone calls and in personal conferences.

Q. And this was prior to the drawing up of the documents and, consequently, resulted in the piece-by-piece sale? A. Yes, sir.

Q. Mr. Penick, would you comment generally on who first established the overall nature of the transaction as a sale leaseback transaction? A. We—Worthen Bank established it as the most logical way and the best way financially from our standpoint to finance our new building.

Q. You have already testified that you first proposed that you own it through a wholly-owned subsidiary. A. Yes, sir.

Q. But that was not permitted, ruled out by the bank [248] regulatory authorities; is that correct? A. Yes.

Q. In establishing the overall transaction as a sale leaseback transaction, was Worthen Bank—would you state whether or not Worthen Bank was motivated by any tax consideration in reaching that determination? A. Well, I think tax considerations have a part in any business judgment. They certainly weren't the motivating force but we certainly wanted to know what the tax consequences were of the ownership of a $9 million building.

Q. Would you refer, please, to Plaintiff's Exhibit 45. This purports to be a comparison of the annual rent for the first three years of the lease, the comparison of the annual rent that Worthen was paying and for which it would get a deduction in its tax return, with a depreciation schedule on a straight-line basis and an interest deduction which Worthen would have got had it owned and financed the building.

Would you state at what—what does that reflect as far as the advantages of ownership, the tax advantages of ownership would have resulted in advantage to Worthen over what period of time? A. The first-up through 1977 it would have been more advantageous for Worthen to own the building themselves. The depreciation and interest would have been slightly in excess of the rent.

[249] After 1977—and the schedule only goes through 1979—it turned around and it would have been——

Q. Had the schedule been extended, these would have been increasing amounts? A. Increasingly larger, yes, sir.

Q. Now I note that this schedule was prepared on a straight-line basis. Had Worthen elected double declining balance, it would have gotten a greater—state what would have been the effect of a double declining balance method of depreciation. A. The advantage would have been more.

Q. In the earlier years? A. In the earlier years. The first seven or eight years.

Q. In the later years would that have been washed out by taxable income? A. Yes.

Q. But basically the reason I believe your testimony has already made clear that the reason that this particular form of transaction, a sale leaseback was chosen was not dictated by tax motivation. A. No, it was dictated by the economics of good business judgment, the best use of our capital and what we would be authorized to do by the bank regulatory authorities.

Q. And, in fact——

[250] The Court: Let's see. By the time the plaintiff company entered the picture, you had rejected other alternatives and you were down to a format of a sale leaseback?

The Witness: Yes, sir.

The Court: At that point, as I understand it, an investor had no choice in the sense of establishing his arrangement with you. He could bid, in effect, in terms of that format only?

The Witness: Yes, sir.

The Court: So the Frank Lyon Company had nothing to do with the establishment of the arrangement, the form of the arrangement.

The Witness: Had nothing whatsoever to do. We were, I'd say, within two weeks of making a decision between the

sale and leaseback proposals we had on hand at the time the Frank Lyon Company became interested.

The Court: Now let me ask you, Mr. Penick: Although on a pure dollar-by-dollar basis, I think you have said it probably would be the most economical way for the bank to do it out of its own resources on a straight basis. On an overall basis, considering the use of your capital for banking purposes and for the success of the enterprise, did you determine that was advantageous ultimately to go this route in order to keep as much capital released as possible?

The Witness: Yes, sir. We had been—every time [251] we'd have an examination we'd have in the last paragraph, as I mentioned, a letter from the supervisory authorities admonishing us that our growth had put continued pressures on our capital account and we should be aware of it and doing everything we could to continue to build the capital account.

We could not do that by trying to put this large a project on our books in the form of real estate, which would be a direct charge against capital.

The Court: All right.

By Mr. Williamson:

Q. Mr. Penick, would you please state then what was Worthen's intention with reference to Frank Lyon Company vis-a-vis, who would own the building between Frank Lyon and Worthen? A. Our intentions were to make the best deal for the Worthen Bank and I'm sure Mr. Lyon and his organization was working to make the best deal for the Frank Lyon Company. Our negotiations with the Frank Lyon Company were completely at arms-length.

Q. And insofar as the ownership of the building is concerned, what was the intention of Worthen Bank? A. Well, the intention of Worthen Bank—we could not own the building. It was our intention, however, in our discus-

sions with any prospective investor, we wanted to make [252] it clear we wanted to control the design of the building, the name of the building, the type of tenant improvements that went into the building. Everything to do, we wanted complete and exclusive control on the image of Worthen Bank as expressed by our building. We didn't want to get anybody's approval on whether to use brick or precast concrete or structural steel.

We had in mind the type of structure we wanted to build and we wanted an investor that was agreeable for us to make those decisions.

Q. Is that not the principal reason for every sale leaseback in which the owner constructs and then sells in order that he can get the type of building he wants? A. I think it's a primary consideration, yes. It was very important to us, however, in this circumstances because we were building an image-type of building for a large financial institution.

Q. But merely because you designed the building—did you employ the contractor? A. Yes.

Q. And the architect? A. Yes, sir.

Q. And Mr. Morse. What was his role, incidentally? Who was he, by the way? A. Mr. Carl Morse is a building consultant from New [253] York City. I mentioned earlier that we had counseled with the officials at the First National Bank of Memphis in their experience in building a building. Mr. Norfleet Turner, who at that time was president of the First National Bank of Memphis, said the first thing I should do as the president of a bank or any group that's getting ready to build a building, said, "Go to New York and hire Carl Morse. He will save you more money. You don't have time to look after the contractor and builder and he will save you more money than you could imagine."

So I did that and hired Mr. Morse. And he did exactly what he said he would do. He controlled the building of the building.

I believe I mentioned earlier that we were building under what to us was a new type of project or program. Rather than have fixed bids, we were building against a budget, and Mr. Morse negotiated the budget items with the contractor and the subs. And on major items, he bought those items himself, like he expressed in the purchase of the elevators. We had eleven elevators and he said, "I'm buying a hundred fifty for other buildings and I will put your eleven in and see if we can better bid," and he saved us a hundred and some odd thousand dollars on our elevator bid. And there were a number of projects of that type.

Q. And Worthen Bank did employ him? [254] A. Yes, sir.

Q. I believe you have stated it was your intention that Frank Lyon Company own the building and was this—I beilieve it is quite clear from the documents that this was a requirement of the regulatory authorities, both state and federal. Is this correct? A. It was not a requirement that the Frank Lyon Company own the building. It was a requirement that——

Q. That you not own the building? A. ——that we not own the building.

Q. Would you please state who the borrower was with reference to the interim financing? A. Frank Lyon Company.

Q. Was this the intent of Worthen Bank? A. Yes, sir.

Q. Who was the borrower as far as the permanent loan is concerned? A. The Frank Lyon Company.

Q. Again, from your point of view, was this the intent of the Worthen Bank? A. Yes, sir.

The Court: All of your intents, so to speak, in this respect are independent of who the investor is. In other words, it would have been the same had it been Goldman Sachs or Dillon or anybody else?

[255] The Witness: Yes, sir.

The Court: And your objectives were dictated, as I understand it, principally by regulatory agencies and your own attitude as to the use of your capital and had nothing to do with the investor's objectives or his intent, so to speak?

The Witness: Yes, sir.

By Mr. Williamson:

Q. Mr. Penick, it appears that one of the contentions of the government is that Frank Lyon Company was a mere strawman in this situation. Would you please comment on that?

Mr. Sayre: Excuse me, Your Honor. I object to the general question as to form. If he has a specific question about the nature of the relationship he can ask him, but just not to make a general speech or comment on something.

The Court: Well, I am going to overrule the objection. The case is being tried to the Court. Sometimes you can shorten the procedure. I think it is obvious what the attorney is getting at.

You may answer.

The Witness: It was not our concern who owned the building: whether it was the Frank Lyon Company or one of the other successful bidders. Our principal intention and our motivation was to build the building at the least cost to the bank and the most effective and efficient manner.

It so happened that the Frank Lyon Company was the [256] successful investor that convinced us they could do that for us.

By Mr. Williamson:

Q. Now in your opinion would you state whether or not this whole transaction was a sham? A. Under no circum-

stances was it a sham. It was a long, well thought out, well developed financing of this building and in no way was there anything of that nature ever entered into any of the discussions or negotiations. They were all on a business-like basis completely, each party representing the best interest of their company.

Q. If the bank regulatory authorities were demanding that Worthen Bank not own the building, would Worthen Bank have been a party to a transaction if the purpose of it was a mere sham to put legal title only but not ownership in Frank Lyon Company? A. We would have had no part of it.

Q. Another contention of the government in this case is that Frank Lyon did not make a $500,000.00 equity—initial equity investment in this building but loaned the $500,000.00 to Worthen Bank.

Would you comment on that? A. That's a theory that I can't follow. I don't see how you could come up with that theory accountingwise or economicwise or taxwise.

[257] Q. Is Worthen Bank——

The Court: Let me ask you just a moment. I just haven't had the time to go over the comparisons of the proposals such as you made in one of—or had made in one of these exhibits.

Under any of these proposals would the investor have had to put up a certain amount of their resources.

The Witness: In each case there was a requirement for equity.

The Court: Let's see if we can find——

The Witness: In our specifications we specified what we would pay.

The Court: Look at Plaintiff's Exhibit 12. How is there anything in there that will show me what the investor in each case was thinking about putting up in terms of its own resources?

The Witness: Well, it will in the specifications on 13. The first specification: Equity be supplied by the investor. We required $500,000.00 and we agreed to pay them an annual rental at the rate of six percent.

The Court: Is there anything in their proposals or prior discussions or negotiations or letters—that is, I am thinking about other than Frank Lyon—which indicated roughly the equities, so to speak, that the investor was contemplating putting in?

[258] The Witness: I can't put my hand on exactly what exhibit, but in one exhibit there are laid out side by side in which I believe the Stephens proposal was to put in $384,000.00 in equity. Goldman Sachs was to put in a similar amount, I believe.

The Court: Maybe Mr. Williamson can help us. Can you draw my attention to any preliminary negotiations, letters, comments, which indicated the investment which the others were thinking about putting in in this preliminary stage?

Mr. Williamson: Your Honor, it is summarized on page 12.

The Court: I was just looking at that. Then it is the next comparison.

Mr. Williamson: Exhibit 15. Your Honor, shows—now it does not show Goldman Sachs. That does not appear.

The Court. I just want to get some idea.

Mr. Williamson: Look on Exhibit 15, the second line "investor equity". Syephenshad proposed to put in three hundred and sixty thousand. Lyon's first proposal was to put in eight hundred and sixty thousand. Worthen had sort of split the difference in its specifications and came up with five hundred thousand, and Lyon's second bid was for five hundred thousand to meet the specification.

The Court: Now in terms of what the controversy [259] over the use of the word "interest" and in your Exhibit 13 the use of the term "rate" in this comparison made on November 2, in the preliminary negotiations, say, with Stephens, did they make a point, in effect, as to what their minimum return on—if they are going to get into this—would be in the sense as to some sort of a rate? Does six percent we find under Stephens, did that come from Stephens' proposal?

The Witness: No, one of them was six and three-quarters.

By Mr. Williamson:

Q. That was Frank Lyon's first proposal? A. One was six and three-quarters and I believe the other two were six.

The Court: But they had it in their proposal?

The Witness: Yes. It is in the exhibit someplace.

The Court: That's all right.

Now as I understand it, in order to get an investor you have to have a package which theoretically is attractive——

The Witness: Yes, sir.

The Court: —is able to attract the investor, something that any investor might be wanting to get into and he has to look at it from two or three aspects, as I gather an investor would: what is the maximum potential I [260] might make out of this under any circumstances on the one extreme, and what is the very least I will make or lose if I enter this transaction.

Now am I correct then in terms of any of these proposals that each would have been required to put up some equity of his own?

The Witness: Yes, sir.

The Court: And Worthen was in a position, in effect, to assure them that at the very least they are going to get, in effect, at that time, I guess, a fair return on their equity?

The Witness: Yes, sir.

The Court: Is that correct?

The Witness: Six percent is what we proposed. In some of the proposals they asked for six and three-quarters.

The Court: And then you go from that, I gather, and say, "Yes", but, of course, you have other advantages depending upon how you can use the depreciation in your own business and depending upon our future decisions, and you may go from this so-called minimum which we more or less guarantee return to progressively very substantial returns on your equity investment, so to speak. Is that the way you approached these people regardless of who they are?

The Witness: Well, yes. I think at the time they were in a little different money situation than we are now in. [261] Many of these firms were seeking this type of investment.

They would be representing maybe other investors or they would divide the investment up, but in money circumstances in 1967 and 1968, this type of investment from investment companies was very much sought after as indicated by the number of companies that came to us when they heard that we were planning a new building.

As I mentioned earlier, we didn't have to do much selling but ferret out the better proposition for ourselves. We had a number of ways we could have gone, a number of companies that wanted to build this building for us.

The Court: All right.

By Mr. Williamson:

Q. Mr. Penick, to follow up on Judge Eisele's line of questioning, in your specifications the first requirement is

that the investor put up $500,000.00 in equity and he could expect an annual rate of return of six percent on that. A. Yes, sir.

Q. That was translated, and as the Judge properly pointed out, that was the minimum that he would make.

Now that was translated into the option prices, is it not—— A. Yes, sir.

Q. —so that if Worthen exercised its option at the end of the 11th year, this is what the investor would have [262] gotten back and this helped establish the—— A. Option price.

Q. —option price. Now——

The Court: And that is the basis for the government theory that you should treat this as a loan and the option will be exercised and that this is the interest, as they say, the investor would get upon his loan.

The Witness: Yes.

The Court: That's the basis for their contentions in that regard.

By Mr. Williamson:

Q. But—and we'll come back to whether or not Worthen is going to exercise that option.

You have stated you did not understand that Frank Lyon Company had borrowed the $500,000.00. Has Worthen ever executed a note? A. Excuse me. I didn't understand.

Q. You stated you did not understand how the government could contend that Worthen had borrowed $500,000.00 from Frank Lyon Company. A. Yes, sir.

Q. Have you ever executed a note to Frank Lyon Company? A. No, sir.

Q. Is Worthen Bank obligated to pay Frank Lyon Company [263] the $500,000.00? A. No, sir.

Q. Is it obligated to exercise its option? A. No, sir. The option all runs all our way.

Q. Is there any way Frank Lyon Company will ever get any repayment of its initial equity in the investment other than through the exercise of the option? A. Only to the end of the 25 years. The equity is building up as the payments are being made. That will——

Q. But if Worthen Bank never exercised its option, will Frank Lyon Company ever be repaid the $500,000.00? A. No.

The Court: Just before we leave it, are there any unwritten agreements or informal understandings of any kind or nature that Worthen will, in fact, exercise any of these options at a given time?

The Witness: No, sir, there's never been any discussion of the intention of the parties as it relates to the option.

The Court: Has such intentions at this time been formed? Has the company made a decision as to what it is going to do?

The Witness: No, sir, we have no decision. I have some information which would be very important as to that type of decision, but we have made no decision on it.

[264] The Court: Ultimately, the decision will be made at the time it should be made on the basis of all facts and circumstances before you at that time.

The Witness: We have just completed in August of this year—we retained the First National City Bank of New York, Corporate Finance Division, to make a study of the capital needs of the First Arkansas Bank Stock Corporation, FABCO, to determine what our capital needs will be over the next five years and the first page of the report, about the fourth paragraph, said that Worthen Bank will require approximately $7.5 million in long-term capital debt over the forecast period in addition to the recent equity infusion. We have added $5 million to the capital

structure of Worthen within the last two years at the insistence of the Federal Reserve System.

This study shows that if our growth continues at the rate it's been going over the next five years, to keep up we will have to put in another $7.5 million. We don't see any way we could entertain even the idea of exercising this option with five and a half million coming out of capital to put in negotiated assets.

If we had to make the decision today we could not exercise the option.

The Court: In other words, on the basis of that report, you'd need more than $12.5 million?

[265] The Witness: Yes, sir.

The Court: Now in terms of your past experience, do you usually get this from your stockholders by preemptive rights or how have you been doing it?

The Witness: Well, up until the time Worthen became a part of First Arkansas Bank Stock Corporation, we did have preemptive rights and went back to the stockholders year after year. When we organized the holding company, the stock went in there and the holding company has furnished the capital to Worthen and has furnished the $5 million of capital over the last two years as required by the Federal Reserve Board.

By Mr. Williamson:

Q. Following up on that line of questioning, Mr. Penick, what is Worthen's present capital stock? A. $10 million.

Q. Do you know what its present investment in bank premises is? A. Total of about nine million.

Q. Do you happen to have a current financial statement with you? A. I have a September 30, the last published statement.

Q. Look at that statement and see what the total investment in bank premises is. Isn't it somewhat more than nine million? A. Nine million, eight hundred eighty thousand.

[266] Q. So that as of right now—and this investment has arisen through more branches, that sort of thing? A. Yes, sir. Through more branches and the Worthen Bank purchased the old Blass building, which we are in the process of remodeling as an operations center.

Q. So right now Worthen Bank is just bumping at its limit on investment in bank premises? A. Yes, sir.

Q. And referring back to that City Corp. report, did you explain to the Court just who City Corp. is, who made that study? A. This is a financial consulting section of the First National City Bank of New York.

Q. And that report stated that Worthen would have to raise an additional $7.5 million new capital by what time? A. Over the next five years.

Q. Now Worthen's first option is at the end of the 11th year on November 30, 1980. Will you state whether or not in your opinion that option will be exercised in view of the capital requirement of Worthen? A. My opinion today is it will not be, and could not be under our current situation.

Q. Under current situations and the forecast of City Corp., in your opinion would the bank regulatory authorities permit Worthen to invest another six million option price at [267] the end of 11 years of something in excess of $6 million? Would the regulatory authorities permit Worthen to exercise the option? A. No, sir.

Q. Let's turn on to the subsequent option period.

There is an option Worthen will have, an option at the end of 15 years, to buy the property for $5,432,600.00; at the end of 20 years to buy it for $4,187,000.00.

Can you at this time state whether or not in your opinion Worthen will exercise either of those options? A. In my opinion at this time they would not.

Q. And would you state why? A. Well, the building is financed and we are comfortable with the financing. We

have an excellent rate of rental payment. The problem that we face is raising capital to support growth, not raising capital to refinance a building.

Also, I don't believe that if we elected to exercise our option—I think we must exercise the option out of retained earnings. I don't believe we have any right to assume the mortgage. In today's interest rate structure, you would be looking at swapping a six and three-quarter percent mortgage for probably a ten and a half percent mortgage, and it just doesn't make good business sense.

Q. At the end of 25 years there is an option to—Worthen Bank will have the option to exercise at a purchase [268] price of $2,145,935.00. Can you state whether or not at this time it is possible to determine that you will exercise that option? A. In my opinion today I don't think we would exercise the option.

Q. Again, for the same reasons you have just given with reference to unlikelihood of exercising the option at the end of the 15th, 20th and now the 25th year? A. Well, the rental drops and then the rental on the—the difference in the rental on the land and the building we'd be living in it in a very, very cheap price.

Q. Would you please explain that to the Court? At the end of the 25th year you will have the choice of either exercising the option or buying the building for $2,145,935.00 or continuing to rent for a period of 40 years, I believe, at what net rentals? A. I'd have to refer to some schedule. I think a net rental the first year is about $300,000.00. The first five years.

Q. Well, to refresh your memory, let's refer now to Plaintiff's Exhibit 46. Let's talk about Section 1 of that exhibit.

You would have an option to purchase the building in 1994 for $2,145,935.00. As of the date you went into this operation and according to the City Corp. report for the

period [269] 1969 through 1973, what average return on capital was Worthen earning? A. Ten point one.

Q. If you were still earning ten point one on capital in 1994 and had an option either to keep this two million one forty-five working in the normal functions of the bank or to invest it in real estate, and you chose not to invest in real estate, at your annual return of capital of ten point one, what return could you expect over the next 40 years, gross return, on that $2,145,000.00? A. We could return $216,739.00 or a total over the 40 years of $8,669,560.00.

Q. Now turning to Section 2 of that Plaintiff's Exhibit 46, to refresh your memory, the building lease following the 25 years, the annual rental was to be $300,000.00 a year. However, Worthen had leased the ground to Worthen Bank for a period of 75 years. Now the first 25 years—the testimony has been brought out earlier that the first 25 years the rent was only $50.00 a year. Would you please state whether there is any significance to that $50.00? A. Well, the $50.00, we were just running the expense up on ourselves. If we had charged a going market rate of $100,000.00 a year for the rent on the land, the owner of the building would have rolled that right into our cost of rent in the building and it would just run the cost up on ourselves. [270] We had the investment in the land and we elected to leave it at a minimum rent.

Q. So it made no difference during the first 25 years what the rent was. A. That's right.

Q. It could have been $50.00 or $500,000.00 and it would have washed out because it would have been fed right back on Worthen.

Now during the second—after the 25 years, though, it's been brought out through bargaining that Worthen was able to establish a ground rent under your ground lease of a hundred thousand a year for the first five years. Now if your rental was three hundred thousand that you had to pay under the building lease to Frank Lyon Company and

Frank Lyon Company, in turn, had to pay you a hundred thousand under the ground lease that would have resulted in a net rental expense to Worthen Bank for the first five years of what amount? A. $200,000.00 a year, a million dollars over the first five year period.

Q. And for the next five year period the rental, ground rent, went up to a hundred fifty thousand dollars a year, which resulted in a net rent cost—the $300,000.00 building lease resulted in a net rental cost to Worthen of how much? A. A hundred fifty thousand dollars a year or $750,000.00. [271] Q. For that five years? A. For that five years.

Q. Likewise, the rent, the ground rent, went up to two hundred thousand resulting in a net rental to Worthen of what? A. hundred thousand dollars a year or $500,000.00 for the five years.

Q. And for the last 25 years your rent, the ground lease rent, stays at two hundred fifty thousand, and the building rent stays at three hundred fifty thousand, so the net rental expense to Worthen is how much? A. $50,000.00 a year for 25 years, or a million, two hundred fifty.

Q. So if you elected at the end of 25 years not to exercise your option, you could look forward to a gross rental expense or a net rental expense over the next 40 years of how much? A. $3.5 million.

Q. So comparing what you could earn on your two million one forty-five, if not put into the building with what your rental expense would be, what would be the net gross economic effect as far as Worthen is concerned? A. It would be to our advantage by $5,169,560.00 to continue as a tenant and not to exercise the option.

Q. Now with that much spread between the two choices [272] you would have, that much economic advantage in not exercising, would you state whether or not your return on equity, your average return on capital, suppose it fell from ten percent down to seven percent, would it still be to Worthen's advantage economically not to exercise the option? A. Yes, sir.

Q. Referring back, you have already commented on it would not perhaps be the best economic use of Worthen's capital to invest in exercising the option after 15 years and put another five thousand four hundred thirty-two thousand in bank premises. Would you estimate whether or not at the end of 15 years the bank would be in a position to do so without exceeding its capital requirements? A. I would think that we would have the capital available. We could do it, but under the regulations—but I don't think it would be the best use of our capital.

Q. Would you comment on—again, as of the end of the 25 years, would you comment on whether or not from physical and functional point of view, Worthen Bank's view of that building from a physical and functional point of view, whether or not it would be a good buy at $2,145,000.00. A. I think that probably at the end of that time it would be a good buy at $2,145,000.00, but if you look at the lifetime of a bank building, the building for some use other than a bank would probably be worth that. But if you look in [273] the lifetime of this bank, how many times it's moved, and it's almost hundred year history, 25 years is about the maximum it can stay in any one place in a functional building.

We moved at Fourth and Main in 1929 and we stayed there a little over 25 years. We shouldn't have. I think we should have moved at the end of about 20 years, but the nature of the business is changing very, very rapidly. It's going to electronic funds transfer positions.

The need for a major office building of that type is becoming less and less and just the changes in the industry could indicate that this building would be obsolete as a headquarters for a banking building.

The Court: In other words, you are talking about the effects in terms of your business of obsolescence and your own business requirement, design changes, public relations as opposed to the deterioration in the building that occurs over a period of time.

The Witness: Yes, Your Honor.

The Court: If properly maintained and still might be a good building—I guess the one you were in from '29 until what?

The Witness: '69.

The Court: —was a good building. Am I correct that those considerations as much or maybe more so as the deterioration in the building that would cause a change in [274] attitude as to your needs?

The Witness: Yes, sir.

By Mr. Williamson:

Q. You have already pointed out it would be the better economic use of $2,145,000.00 for the bank not to put it into a building but to use it in the banking facilities, make money in your normal operations.

At the end of 1965 Worthen would no longer have a building lease. Your building lease runs out at the end of 65? A. After 65 years.

Q. After 65 years. I'm sorry. A. Yes.

Q. After 65 years do you think it would be of great concern to Worthen Bank not to any longer have a lease at 50,000 a year and be placed in a position to have to negotiate for the lease? A. No, because we still own the land. The owner of the building would have to negotiate with us to maintain the building on our land. I think we would be in a strong position.

Q. Do you think Worthen Bank at the end of 65 years would still be in that building? A. I would think not if history repeats itself. I think we probably would have gone through another building besides this one by that time.

[275] Q. Mr. Penick, has it ever concerned you that Frank Lyon Company itself might be sold? A. Yes. It became one of the items of negotiation in the making up of the agreements.

Q. Did you request from Frank Lyon Company assurance that if Frank—that the ownership of Frank Lyon Company changed that Worthen would have an option to buy that property? A. I believe that's in the agreements.

Q. I don't believe you will find it in the actual agreements themselves.

Mr. Williamson: Your Honor, I am going to introduce as Plaintiff's Exhibit No. 50—I would like to offer into evidence as Plaintiff's Exhibit No. 50 a letter from Frank Lyon to Ed Penick dated April 12, 1968.

The Court: Has Mr. Sayre seen this?

Mr. Sayre: I have just seen it. I have no objections to it.

The Court: All right. It is received. Let me read it just a moment.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 50 and was received in evidence.)

By Mr. Williamson:

Q. Would you please state what led to that letter, Mr. [276] Penick? A. I can't recall exactly the circumstances. I know that a number of major appliance companies have started going to their own national distributorships and at that time I think a number of them in our community, such as Philco and General Electric, went direct and I believe my concern was can this happen to RCA distributor, which is the Frank Lyon Company.

Q. Were you concerned primarily with the ownership of the building after the 25 year period? A. No, I'm concerned with the ownership of the building now. Anytime during that period it would change.

Q. Would you state what the price is at which the building would be sold in the event Frank Lyon Company changed hands? A. It was a negotiated price.

Q. And presumably that would be the fair market value at that time, would it not? A. Yes.

Q. And would you expect that to continue after the 25 years when you no longer had an option to buy under the agreements? A. I would think from this letter it would carry through the lifetime of Mr. Lyon's immediate heirs and the current working associates in the Frank Lyon Company.

[277] Q. Who currently own some stock in the company? A. Yes.

Q. I believe that was indicated.

I believe you have already stated in response to the Court, if I heard you correctly, but I will ask you again: Was there any understanding at the time, either written or oral, at the time these documents were entered into that Worthen Bank would ever exercise its option to purchase? A. No. It was never discussed or never a part of any of our negotiations.

Q. At the time these documents were entered into in May of 1968, was there any commitment on behalf of Worthen Bank to make a $500,000.00 loan to Frank Lyon Company equal to its equity investment in the building? A. Not a specific commitment. But the Frank Lyon Company has enjoyed our maximum legal lending limit for many, many years and in that way it would have been available to the Frank Lyon Company as long as they weren't over our legal lending limit that was a million eight. As long as they had not exceeded that they utilized that line as their money demands required.

Q. Was there any discussion at any time that Worthen would loan Frank Lyon Company $500,000.00 to put into this building? A. No.

[278] Q. Did the loan of $500,000.00 in August of 1969 at the time Frank Lyon Company bought the Coca Cola stock, was that loan made—have anything to do with Frank Lyon's $500,000.00 investment in the building? A. Not

to my knowledge and not from the standpoint of Worthen Bank. He had already put the money into the building at the time that came up because the building was 95 percent complete by August of '69.

Q. And you understood that $500,000.00 loan in August of '69 to be for what purpose? A. To purchase a down payment on—to purchase the Coca Cola Company.

Q. Incidentally, referring back to this letter of April 12, 1968, is there any legally binding obligation to sell the building, or is this simply a moral commitment?

The Court: I am not going to need the opinion of Mr. Penick on that.

We are going to have a recess for 15 minutes.

Court will be in recess.

(Recess.)

By Mr. Williamson:

Q. Mr. Penick, you testified earlier in the morning you would never have made reports to the bank regulatory authorities reflecting this transaction as a sale leaseback arrangement if it were a mere sham. During this period, or [279] since this period, have you had to file any report with the Securities and Exchange Commission? A. Yes, sir, we have. In organizing our holding company and the acquisition by the holding company of Worthen Bank and the First National Bank of Hot Springs, we filed registration with the Securities and Exchange Commission. We filed registrations on the acquisition of the National Credit Corporation in Pine Bluff, and this last year we filed with the SEC with the intention of having a public equity offering but withdrew it when the market turned around.

Q. But in all these prospecti, perhaps is the word, has this sale leaseback transaction been reported? A. Yes, sir.

Q. And in your financial statement has the building been carried on Worthen's books as being the owner? A. No,

it's been footnoted by the accountants as a major transaction between the bank and a director, but only in that form.

Q. Hadn't this been a mere disguise of a sham transaction and Worthen Bank being really the true owner of that building, would you or your directors have permitted a prospectus to be filed with the SEC that was misleading? A. No, sir.

Q. Would there be any civil or criminal liabilities exposure to civil and criminal sanction of your board of [280] directors had this been a mere sham? A. I understand it would have been, but it's never been a point of discussion because it was not a sham in any shape or form.

Q. Was Worthen Bank allowed a deduction for the interim interest of some $450,000.00 which Frank Lyon Company paid to First National City Bank on the interim loan? A. No, sir.

Q. Was Worthen Bank allowed any current deduction for any legal or audit expenses in connection with this transaction? A. I don't think a deduction. I think we capitalized—

Q. No, they were paid by Frank Lyon Company? A. No.

Mr. Williamson: No further questions.

The Court: All right, Mr. Sayre.

The Witness: May I volunteer a question? You asked me awhile ago where there was anyplace in these exhibits where I could show the equity proposed by the different proposals and I was not able to find it at that time. It is under Plaintiff's Exhibit 15.

The Court: Yes, I think Mr. Williamson noted that and I find it here. "Lyons (2), $500,000.00; ours, $500,000.00, Lyons (1) $860,000.00; Stephens, $360,000.00."

[281] The Witness: Yes, sir.

CROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Penick, you said that the bank, Worthen Bank, had a verbal commitment from First National City Bank, your correspondent bank in New York, for the interim financing and from New York Life for the permanent financing, subject to finding a suitable investor, an acceptable investor. A. Yes.

Q. So that the bank had arranged for both the interim and permanent financing of the Worthen Bank Building. A. Yes, sir.

Q. And you said that the bank wanted to make absolutely sure that it kept complete control of, I believe you said "our building" or "its building" because you considered it to be, in effect, your building; is that correct? A. Considered it to be the headquarters of our business organization.

Q. But the image of the building was important? A. That's right.

Q. And it was to be dictated exclusively by the Worthen Bank or the directorship of the Worthen Bank? A. The design, layout and construction.

Q. I'd like to draw your attention to Defendant's Exhibits 8, 9 and 10, and ask you to identify those, please. [282] A. Eight is a standard form of contract between owner and architect by the American Institute of Architects.

Q. That was entered into between the bank and the Erhart architectural firm? A. Yes.

Q. This is the architectural firm that prepared the final plans for the building? A. Yes.

Q. That was after the problem over the alley had been straightened out, and the building as it now stands on Capitol was designed by the Erhart firm? A. Yes.

Q. It was designed for the bank? A. Yes.

Q. And Frank Lyon Company had nothing to do with the hiring or design of the building? A. None.

Q. Now with regard to Exhibit 9, would you identify that one? A. This is a letter in the form of a contract from the Carl A. Morse, M-o-r-s-e, Inc. addressed to Worthen Bank and Trust Company to my attention, which is outlining the working relationship for the retention of Mr. Morse as company services—as a consultant in the building of this building.

[283] Q. Again, this contract was entered into in, I believe it is 1967? A. '67. February of '67.

Q. February of '67 would have been some eight to ten months prior to the time that you finally made the decision on the sale and leaseback. Is that correct? A. Before we finally selected the Frank Lyon Company, yes.

Q. Or even the methods: whether it was to be a holding company or a subsidiary or a sale and leaseback? A. Yes.

Q. So the bank had made the commitment to build the building and hired architects and had hired an overseer; is that correct? A. A consultant.

Q. As outlined in that letter there, their responsibilities were to oversee the construction of the building. A. He was to work with the architectural firm in the design of the building and in the receipt of bids from subcontractors and the control of those bids within a prearranged budget.

Q. And he was to act on behalf of the bank? A. Yes.

Q. In dealing with those people? A. Yes.

[284] Q. Now would you identify Exhibit No. 10? I believe that's the front and back page of a rather lengthy instrument. A. It's without a title but it evidently is the contract between Matson Bellows, a joint venture between Maton, Incorporated and W. S. Bellows Construction Company and Worthen Bank and Trust Company for the construction of the building.

Q. And when was that entered into? A. That was entered into November of '67.

Q. When was the ground broken on the building, excavation begun? A. I believe it was September of '67.

Q. So prior to that time there was a contract with a prior contractor or did Bellows do it without a contract? A. They did it without a formal contract.

Q. So the bank itself actually had commited itself to the construction of this building and had hired architects, made plans, and hired a consultant and had actually started construction in September of 1967 at about the time that it was finally decided on whether to use a holding company, a subsidiary, or a sale and leaseback; is that correct? A. We had been working on that all during the year of 1967.

Q. But the final decision with regard to Mr. Wyrick and the regulatory agency came in September, I believe, of [285] 1967.

So about that time, the bank, though, had been—actually began construction of the building itself. A. We had started construction of the building. We knew we were not going to be able to finance it on the balance sheet. We were going to go off balance sheet with it early in 1967. We knew we could not finance it ourselves.

Q. Now with regard to the amount Worthen Bank was carrying on its balance sheet at that time, I believe you had capital of about $4 million? A. Correct.

Q. And you had capital and unrestricted surplus slightly in excess of that amount, four point four million, something like that? A. Right.

Q. The land cost about a million four hundred thousand? A. Right.

Q. And the construction of the garage was estimated at a million two hundred thousand? A. Yes.

Q. So approximately two point six million totally to be invested by the bank? A. Yes.

Q. Now it was also contemplated that the bank would have other expenditures to put into the building; is that correct? [286] A. Yes, sir.

Q. And that was to run up to the maximum that would be allowable under the capital structure? A. $4 million.

Q. So that the bank when it went into this was going to put in another approximately $1.4 million into the building; is that correct? A. One point four million into the building?

Q. You had two point six million in the parking lot and the land and you were going to try to carry as much as you could on your books. A. I think it is pretty well outlined in some of these exhibits, if I can refer to the particular figures.

Q. Certainly. A. In September of '67 in a letter to Mr. Adams in which we sent projections that we would have a total of $4,353,000.00 in land, building and leasehold improvements, we would sell the existing building or carry that figure of $600,000.00 which would bring us down to a total of three million seven hundred fifty-three thousand on our books.

Q. So three million seven. And the bank anticipated putting a million one, two or three hundred thousand into the new building? A. Yes.

Q. And I believe yesterday Mr. Cotham's testimony that [287] this was to be specialized banking equipment such as the vault, this type of thing? A. Leasehold improvements.

Q. He also said the leasehold improvements included things like paneling and built-ins and paint. Was there a cost overrun on the building in excess of the amount estimated? A. No.

Q. So it came in on budget then, and part of the ownership of the leasehold improvements are in things such as paneling on the walls and this type of thing? A. Really I think some is in improvement. I don't know specifically about paneling on the walls. Certainly I wouldn't think paint as being in leasehold improvements. That's a standard building product.

Q. Do you know what makes up the total amount one or two million dollars? Is this identified? A. It is identified on the books of the bank. I could get you that. I don't personally know exactly how it's broken down.

Q. At any rate, the total amount that Frank Lyon Company or the price agreed to in the sales agreement was seven million six hundred forty thousand and that was a firm price. The bank would finance on its books any amount in excess of that amount? A. Up to the maximum permitted by the regulatory [288] authorities.

Q. As you earlier stated, the bank wanted to finance as much as it could up to the four million because it was cheaper for the bank to finance it on the books. A. Yes.

Q. The cost of money was about five or five and a half percent to the bank? A. Yes.

Q. Also I believe that once the bank had made the decision to go with the sale and leaseback you wanted an investor that would not interfere with the bank's plans; is that correct? A. Yes.

Q. In other words, you wanted somebody—as far as the construction of the bank and the types of materials or who the contractor was—was to be passive. They were to make only an investment; is that correct? A. That's right.

Q. All during this period of time would you explain to the Court what steps were taken or how physically the construction of the building took place? In other words, who oversaw the construction of the building besides Carl Morse Company? A. We had an employee called clerk of the works that was on the building site. Of course, the architectural firm [289] oversaw it. We had a man on our staff that was the building projects manager from the bank's standpoint that was housed in the main bank and had the main responsibility of leasing the building.

Q. The clerk of the works then was an employee of the bank who would be on the job site? A. That's right.

Q. Did Frank Lyon Company have anybody on the job site? A. No. Not to my knowledge.

Q. Excuse me. I served a subpoena upon you asking you to bring various documents, many of which you and Mr. Williamson, through courtesy, have gone through and

pulled out the Defendant's Exhibits 8 through, I believe, 17.

Also there is—I requested you to bring daily work reports of contractors or architects. Those have been produced. I don't see them right now.

The Court: Mr. Sayre, what is the purpose of this? If I'm not mistaken, the purpose is to make clear that the investor, the plaintiff here, had nothing whatever to do with the control of the construction, the design of the building, the supervising of the construction.

Mr. Sayre: That is correct.

The Court: It is conceded, admitted and not at issue. We can keep proving it.

Mr. Sayre: I will try to terminate it then.

[290] The Court: It is unnecessary.

By Mr. Sayre:

Q. Then, Mr. Penick, with regard to those reports, there was a report for each day submitted by the contractor to the bank; is that correct? A. They didn't come to my knowledge. I don't know they were submitted but it didn't come to my office. I'm not familiar with them.

Q. Would you please refer to Plaintiff's Exhibit No. 13? The fourth paragraph, which is one line long, says that all investment tax credit and tax savings will accrue to Worthen Bank.

It was the desire of Worthen to save approximately a hundred twenty-five thousand in sales tax? A. Yes.

Q. By buying the materials, putting them into the building and then, as the contract reads, I believe, sell the building to Frank Lyon Company brick by brick, or as the material was put in? A. Yes.

Q. And the investment credit, the federal income tax credit, was passed on to Worthen Bank then? A. Yes.

Q. This is on the material placed in the building? A. Yes.

[291] Q. Now with regard to the specific items, paragraph one says "equity to be supplied by investor $500,000.00, and annual rate of interest to be charged thereon, six percent."

Why did the bank use the term "rate of interest" which indicates a debt or a loan with interest to be charged on it? Why did it choose those terms? A. Well, I think you could put rate of return. I think we deal in interest, and the person writing this up—it's just a clear expression that that's the rate we would pay on the equity.

Q. And I believe you stated the amount was calculated by taking what the option prices would be and making—if the options were exercised, that the amount to be realized would be six percent on this $500,000.00? A. No, I think—I think it was the other way around. That the rate of return we would pay determined the option price.

Q. What I'm trying to get at, the option prices were determined to give the investor a six percent return on the $500,000.00 if and when an option would be exercised? A. That's right.

Q. Do you know why there was a change between the rent—not the rental payment—yes, rental payment here, after 11 years? A. Yes.

[292] Q. Why is that? A. Well, I think that's explained in the second paragraph. Instead of having 11 payments for the rent, we wanted to pay the rent—we wanted the first ten or eleven years the opportunity to get rented up and get comfortable in the building. We didn't want to make straight 25 year level payments. If we paid the first 11 years 90 percent of those payments that would have been necessary to retire that percentage of it and made it up in the next 14 years, and that's explained in the second paragraph of Exhibit 13.

Q. With regard to the actual leasing of the building I believe you stated at one time or the other—

The Court: Let me read that paragraph.

All right. Go right ahead.

By Mr. Sayre:

Q. The leasing of the Worthen Bank Building has been highly successful by the bank; is that correct? A. Yes, it has.

Q. And the bank's rental is equal to the debt service required on the permanent financing, correct? A. The amount that we received.

Q. Your rental under the net lease? A. The rent that we pay to the Frank Lyon Company, yes.

Q. And then you have the right to sublease space within your building; is that correct? [293] A. Yes.

Q. And that has been a profitable venture for the bank? A. Well, it depends how you calculate it accounting-wise. We have been able to live in the building at less than we originally projected it. When we charge ourselves our cost of occupancy, we still pay substantial amount to use the building ourselves.

Q. How much does the bank occupy, how many floors? A. We occupy a hundred ten thousand square feet of a total of about three hundred fifty. Floorwise, we occupy the most part of ten floors. However, we don't occupy all of them exclusively. And we charge ourselves with—there's one floor, a public floor, the fourth floor, doesn't have anything but meeting rooms and conference rooms on it and we charge ourself with it.

Q. On the second page—

The Court: Let me interrupt just a moment. Back there in August or September, getting ready to build—in fact, I think you started in September—how much of the building had been leased?

The Witness: When we started just the part that we wanted had been actually leased. We had some letters of intent.

The Court: How many letters of intent? Of course, this was looking—when did you open for occupancy?

[294] The Witness: December of '69.

The Court: How many letters of intent did you have in terms of other tenants who might sublease?

The Witness: By number, I think it would be very few. By square footage, we had some pretty substantial indications of interest because, as I mentioned, the Tower Building tenants were coming up on ten year anniversary of their leases. We were working very hard on some of their tenants and we had indications of interest.

The Court: Would you say you had indications of interest as to any occupancy of any square footage in the building?

The Witness: Yes, I would estimate of the total square footage in the building including the space Worthen would occupy—and at that time we had projected moving our computer operation into the building—that we had about 60 percent projected occupancy.

The Court: By the time you started building?

The Witness: By the time we started building, yes, sir.

The Court: You may continue, Mr. Sayre.

Mr. Williamson: Your Honor, I didn't quite hear the last remark.

The Witness: Sixty percent.

Mr. Williamson: By the time you started building?

[295] The Witness: Including Worthen's space we projected using. We had originally projected moving our com-

puter operation and our proof and transit, which would have taken two floors. As it turned out, we did not move them into the building but at the time of September of '67 we were going to move them into the building.

By Mr. Sayre:

Q. Following that up, how did the rentals go after construction actually began or commitment? A. They went very well.

Q. And by the time the building actually opened, was it virtually rented? A. By the time it opened there were leases signed or letters of intent for over 90 percent of the space in the building.

Q. Now on page two of Exhibit No. 13, there is a paragraph five, which has the options of Worthen Bank to repurchase subject to assumption of the mortgage by Worthen. What are those figures in parentheses out there? The discount amounts or discount factors? A. I can't figure exactly what those are unless it is the difference between six and six and three-quarter percent. And I didn't calculate them.

Q. That would be then the return on equity investment by a potential investor? [296] A. That's right.

Q. And savings to the bank would be that discount factor? A. Yes.

Q. The difference between the payment to the—excuse me. The interest on the long term financing? A. Yes.

Q. Now with regard to that, you stated earlier in response to a question of Mr. Williamson that the bank would probably not exercise the option because of a difference in interest rates. Doesn't the Worthen Bank have the right to assume the mortgage, if it chooses to exercise the option to purchase, to assume the mortgage at the interest rate stated? A. Yes, but we would have to come up out of our own capital with the difference to pay this off.

Q. Or you would have to have an infusion of capital through another issuance of capital debentures or equity?

A. When we assume that mortgage we would have to show it as a liability on the statement.

Q. But you said you would have to—I think you said you would have to change your interest rate from six and three-quarters to ten and a half. My question is: If you had an equity offering you mentioned and infusing capital by way of equity, you could assume that mortgage at six and three-quarters? [297] A. Yes.

Q. From New York Life? A. Yes. But only in Worthen. We could not if we went off the balance sheet. I don't believe the right to assume is assignable.

The Court: Let me ask in connection with, say, any options prior to the paying off of the loan. Is there a specific provision on these instruments contemplating that possibility in terms of New York Life? Did they contemplate or take into consideration in their documents the possibility of the bank exercising these options at some time prior to the termination of the loan?

The Witness: There are penalty provisions for prepayment.

The Court: Well, there are prepayment penalties. Let's say the bank exercised its option at the 15th year. Is there any provision in there that the plaintiff would be released by New York Life from its obligation under the note and mortgage upon the bank's exercising the option and assuming? It is clear it has the right to assume the balance. But the question is is there a further provision that in that event the plaintiff is released from its obligation?

Mr. Sayre: I do not recall, Your Honor.

Mr. Giroir: I don't recall, Your Honor, but I will look it up and see.

[298] The Court: Absent such a provision, the plaintiff would continue liable, unless someone corrects me, upon the note, and if the bank defaulted the plaintiff would still be obligated. Is that not correct? Absent some release?

Mr. Williamson: That would be true as a general principle of law.

The Court: Unless there is an agreement to the contrary. All right, I wanted to get that clear.

By Mr. Sayre:

Q. In arranging the financing with City Bank and also with New York Life—and this was done, I believe, in the summer of 1967—you had a commitment from them—— A. Yes.

Q. —prior to the start of the building?

That as part of that commitment the bank agreed to pledge or mortgage or subordinate its interest in the land and the parking garage as additional security for both the interim financing and the permanent financing; is that correct? A. That's correct.

Q. Why would the bank agree to pledge its unencumbered assets for the loan of, I suppose, unrelated third party? A. I think for two reasons. The first primary reason is the interest rate. The better quality of loan we could make the better interest rate we could anticipate getting from both the interim and the permanent lender.

[299] Second, it was a single unit. The parking deck was not workable without the building; the building was not workable without the parking deck. We were behind it from the standpoint it was going to be our office building and we had the assets there and we could help ourselves. We were going to pay the interest in the long run. It made sense to us to provide that additional equity.

The Court: Let me ask you this: As of September or prior to the time Frank Lyon came into the picture, were those arrangements already negotiated? Was it understood with interim and permanent financing that you would subordinate this investment to the mortgage of each as additional security to them?

The Witness: Yes. Yes, sir.

The Court: And indirectly then you get the benefit through better terms and I think you are also saying it is an economic unit. No mortgage would take one without the other because it wouldn't operate, in effect.

The Witness: Yes, sir.

The Court: Those determinations were made before the plaintiff entered this picture and would have obtained, I gather, whether the plaintiff was successful or anybody else——

The Witness: Yes, sir.

The Court: —was successful as the investor?

The Witness: It didn't make any difference who was [300] the investor. We were looking at the overall ultimate cost to us. We were going to have to pay the interest rate regardless of who owned the building. If we could negotiate one half of one percent or three-fourths of one percent better by using the additional security of the land, we thought it was to our best interest to do so.

By Mr. Sayre:

Q. With regard to that, Mr. Penick, you are saying then that the bank's purpose for finding an investor was to satisfy the Federal Reserve requirement of getting the title to the building or determined ownership of the building off the balance sheet; is that correct? But that in a practical effect, the costs of the building were going to be passed through to the Worthen Bank to pay the financing off; is that correct? A. Yes.

Q. And this was understood and calculated prior to the time even that Frank Lyon got into the picture? A. Yes.

Q. It was the bank's arrangement with New York Life and with First National City Bank? A. Yes, that's right.

Q. Now with regard to the ground lease, the $50.00 figure was set, again, by the bank so that there would be no increase in rent on the property? A. To ourself.

[301] It was considered as a wash by the bank? A. Yes.

Q. So that the bank was putting up this building and receiving financing—had commitments for financing and was going to pay it, as I think you said, indirectly so it was a cheaper method for the bank to continue to own the ground under the two structures: the parking garage. A. One of the primary objectives was to get into the building at the least cost to us. One way we could do that was not to run the cost up on ourselves: whoever the investor may be, by not charging him a ground rent which he would have to roll into the rent he, in turn, would charge us. I was a washout.

Q. I believe you originally said that the plan was to get a holding company formed as a subsidiary to issue additional debentures. These are considered capital as far as the federal regulatory agencies go. A. Yes.

Q. To issue that amount, turn that money over in return for stock of the subsidiary and then have the subsidiary borrow money on the outside. But the reason that this wasn't done was because of the state requirement of payment of six percent interest would not have floated or caused the bonds to have been sold in the market at that time? A. There were two reasons. That was a reason we were not familiar with that provisions of the Arkansas law at that time. The second reason was that Mr. Wyrick told us any [302] investment in a wholly-owned subsidiary would be changed the same as the investment in real estate, so we accomplished nothing.

Q. But it was the bank's intention originally, the plan that had been chosen and you started to go through with it by asking for approval, would be to acquire or cause another $4 million in capital to be created on the bank's books? A. We were exploring any way of financing—the best way of financing this building. We had not zeroed in on any one plan until we developed sale and leaseback as the best method for us.

Q. Some decision had been made when you went to the regulatory agencies to request their permission. A. Yes.

Q. And I believe in the correspondence you said you scrapped that plan because you couldn't float the bonds; is that correct? A. Yes.

Q. Or the debentures? A. Right.

Q. So at that time the bank did not have any qualms about creating another $4 million in capital that would be tied down or held because it was the cheapest way for the bank to go to build the building; is that correct? A. That's correct.

[303] Q. The options that appear on Exhibit 19, which is the building lease and also on Exhibit 13—they are referred to on 13 and I believe the final options appear on 19, probably paragraph 20.

The Court: Do you know the page?

Mr. Sayre: Twenty-five.

The Court: All right.

Mr. Sayre: Could I ask the clerk to borrow the stapler?

By Mr. Sayre:

Q. Could you tell the Court, please, how these dates were determined and how the purchase price was determined? A. I am not familiar with exactly how those were determined.

Q. Didn't you testify earlier that the purchase price was determined on the basis of the outstanding debt or the unpaid principal of the mortgage plus a six percent factor on the five hundred thousand was the way we got the purchase price? A. No. I said the amount we would pay the investor was determined by the interest rate factor plus the amount of his equity. I don't believe I said the unpaid balance on the note. Evidently, that is the way that was determined.

Q. How were the dates determined: the 11th, 15th, 20th and 25th year? And why were they chosen? A. I don't remember.

[304] Q. You were on the finance committee that worked on this, weren't you? A. Yes.

Q. Do you remember any discussions about it or discussions with Mr. Gates about it? A. No. Well, the 15th year sticks in my mind because that's when the bank commissioner insisted that we have in our right to purchase, and the other I don't know why they were just chosen on five year intervals.

Q. Do you recall any discussion—and you said you looked at the tax consequences of this—any discussion that Internal Revenue code provided a penalty for recapture of excessive depreciation if a building was held for less than ten years, but no recapture subsequent to that time and that this would be a factor that would make it attractive to an investor? A. I'm not familiar with whether that went into those provisions or not, but I do know that, of course, we wanted to take advantage of the provisions of the tax law where it was at our best interest to do so.

Q. Now with regard to Defendant's Exhibit No. 18, which is the record Frank Lyon's journal entry of the loan, the Coca Cola loan was made in 1969 for about $500,000.00 and for one year. Now with regard to the testimony, it's been to the effect that the bank and Frank Lyon worked out a deal where the [305] bank would recover its hundred and five thousand dollars and promised rent reduction on the first five years of the lease through increased interest charges paid by Frank Lyon. Is that in essence the deal that was worked out? A. I think the arrangement was to pay us increased interest in order to meet the obligation of the reduced rent which they were unable to do, due to the fact New York Life did not permit the contract to be drawn with that provision in it.

Q. And that agreement was reached between both representatives of the bank and Frank Lyon Company. It

was understood that the excess rental over the prime rate or their usual lending rate would be applied to reduce an obligation of a hundred five thousand dollars connected with the reduced rentals? A. Yes.

Q. And I believe your testimony has been that to date only about one-fifth of that about has been discharged. A. Yes.

Q. And why hasn't the rest of it been discharged? A. The interest rates in Arkansas couldn't go over ten percent. There wasn't any way. The prime rate went to 12 percent. There's been no way to pay rates in excess of ten percent so we will have to work out another arrangement.

The Court: Although it's been somewhat—since '69 [306] that differential only existed there for a short period of time and upon the renewals, in effect, they are not paying you anything more than they would have to pay otherwise.

The Witness: That's right.

The Court: Under Arkansas law they can't pay above ten anyway. Is that the answer?

The Witness: Yes, sir, that's the answer. It is easy calculated as to the total amount still owed. I have not calculated but the total amount owed under an obligation of a hundred five thousand dollars can easily be computed. It's a recognized obligation from the Frank Lyon Company to the Worthen Bank and it will be paid, I'm sure.

By Mr. Sayre:

Q. And the interest was raised to ten percent on this note, I take it, and the maximum has been charged? A. I feel sure that it was, but it is a year's note.

Q. That's what I am asking: When it was renewed would the interest rate be adjusted? A. It would have gone up to that figure.

Q. Then why has the bank continued to renew this on a yearly basis, and if the interest rates are going to remain does the bank plan to continue to renew this note? A. Well, circumstances being the same, the quality of the credit continuing good—that's the purpose of handling it on a year-to-year basis—that it would be our intention to [307] renew it as long as the Frank Lyon Company enjoys the esteem of our organization.

Q. So you are saying originally there was no agreement to make a loan of $500,000.00 to Frank Lyon Company at the time they made an investment in the building of $500,000.00. A. Never mentioned or discussed.

Q. But that the interest on this $500,000.00 loan for the Coca Cola stock was tied into the repayment of a reduced rental on the building financing; is that correct? A. Well, the interest was in payment of an obligation of a hundred five thousand dollars, which had originally been the commitment to reduce the rent by $21,000.00 a year. When that became unacceptable to New York Life Insurance Company, it did not detract from the fact that $105,000.00 obligation still existed between the Frank Lyon Company and the Worthen Bank.

Q. Excuse me. My question was that obligation was tied into the interest on this loan and was to be reduced through that method? A. The $21,000.00 obligation arose out of the original agreement in the sale and leaseback.

Q. But the repayment or the payment of that $105,000.00 obligation was tied into the interest factor on this loan? A. Yes. But not at the original inception. I thought your question was the original inception at the time. It was [308] not.

Q. This was at the time this loan was created. A. Yes.

Q. This Coca Cola loan was created. A. Yes.

Q. And your statement is that as long as Frank Lyon Company wants to hold that out and pay the going rate of interest the bank will continue to renew these one year

notes; is that correct? A. As long as the quality of the credit remains the same.

Q. I believe you said there was a credit line of some $2 million. A. Yes.

The Court: Let me see if I understand. The plaintiff has enjoyed a good relationship with your bank for a long time.

The Witness: Yes, sir.

The Court: And do I understand that from let's say September of 1967 or prior to that on up to now that it's had a line of credit with your bank?

The Witness: Yes, sir.

The Court: And that line of credit has been and is $2 million?

The Witness: It's been our maximum legal limit as [309] a state bank. It was 20 percent of our capital and surplus which was a million eight, and now as a national bank it is two million eight. We have added additional capital to it. They enjoy our maximum legal limit.

The Court: And that depends on your own balance sheet, so to speak——

The Witness: Yes, sir.

The Court: —as to what their maximum credit line is with you?

The Witness: Yes, sir.

The Court: Was it changed at any time as a direct result of their agreement to act as an investor or was their credit line completely independent of this agreement or simply followed your own balance sheet in terms of your most favored customer?

The Witness: They have enjoyed our maximum legal limit to my knowledge for 20 years and its's always been in

excess of the $500,000.00 that is in question, and in no way did the credit relationship of the Frank Lyon Company tie into their financing of our building.

The Court: That will be clear because people use the term loosely "a line of credit". All that means is you cannot lend to this particular customer more than that amount by virtue of law. It does not constitute in any way any commitment to make any particular loan, does it?

[310] The Witness: No. By matter of law it means when we issue a line of credit to a company that we will hold that amount of credit available for them, but it is considered to be normal commercial credit. That's normally that they would come in, borrow it for a short term period for inventory and accounts receivable and repay it.

The Court: When you take up a loan to buy stock——

The Witness: It's different negotiations generally, and if the loan is to be of a term nature that's normally outside of the regular line of credit.

The Court: All right.

By Mr. Sayre:

Q. And it was understood at the time this loan was entered into that even though it was a one year loan that it would be on a long term basis? A. We understood there probably would be no repayments until after the stockholders of the Coca Cola Company had been paid and that payment, I believe, was over a four or five year period.

Q. And no payment has been made to date; is that correct? A. Not to my knowledge.

Q. And some five and a quarter years has expired since that time? A. Yes.

[311] Q. Now the the Worthen Bank shortly—in the time between 1967, '68, '69 when the building was planned and constructed and the present time, the bank has changed its

charter from a state bank to a national bank; is that correct? A. Yes.

Q. And it is under the control now of the Office of the Comptroller of the Currency? A. Yes.

Q. What are the restrictions on the bank on building requirements again and ownership with regard to the Comptroller of the Currency? Are they the same as the Federal Reserve? A. They are not as specific. I believe forty percent of your capital in surplus is about the maximum that the Comptroller will permit, and he has a good bit more flexibility in the rules and regulations than the Comptroller does.

Q. You mean than the Federal Reserve does? A. Excuse me. Than the Federal Reserve does.

Q. The Comptroller of the Currency would allow forty percent of the capital and unrestricted surplus or any surplus? A. I think it's any surplus.

Q. What was the surplus of the Worthen Bank. You said the capital was—— A. It's five million also. However, the important point to us is we are not from under the Federal Reserve because under the Bank Holding Company Act of 1970, the Federal Reserve [312] still dictates to us our capital ratios. It was the Federal Reserve that required us to put in the $5 million. We were a national bank in 1972 when we put in the $5 million additional capital.

It was a Federal Reserve through the workings of the Bank Holding Company Act that required that additional capital and not the Comptroller.

Q. When you say "the workings of the Bank Holding Company," does it refer to any bank or because you have state banks within your holding company? A. No, Bank Holding Company Act refers to any company that owns a bank.

Q. So as long as the FABCO entity is in existence Worthen and FABCO will be under the control of both the Comptroller of the Currency and the Federal Reserve. A. That's right.

Q. Now with regard to the testimony you said with the SEC you had an equity offering that was going to be brought on the market or intended to be? A. Yes.

Q. How much capital was to be raised through that equity offer? A. We were trying to net $6 million.

Q. And what was the purpose of that? A. It was to supply the capital to the holding company [313] that would be needed.

Q. To FABCO? A. To FABCO. It would be capital acquired on the holding company level and be needed to fund the capital requirements of the subsidiaries.

Q. So in other words it would be passed through—the capital would be passed through to each bank that was a subsidiary as needed?. A. Yes.

Q. You said there was an infusion of $5 million in the last two years? A. Yes.

Q. So you now have $10 million in capital? A. Yes.

Q. Did part of this infusion of capital, was it required because of the acquisition of the old Blass building and conversion into a center? A. No. It had no part of that.

Q. Has the bank purchased and carried on its books the old Blass building? A. Yes.

Q. What is the anticipated cost on remodeling? A. The cost of the building was about nine hundred sixty-five thousand. We will receive—there is a lease outstanding on it from Dillard Department Stores, and over [314] the term of that lease I think we will receive about $450,000.00 and the building will net costing us a little over four hundred fifty or five hundred thousand dollars. The remodeling is going to cost about a million and a half.

Q. So the investment on the books will be between two and two and a half million dollars; is that correct? A. Yes.

Q. And that was covered by the infusion of new capital? A. Well, that is the only reason we could go up that high is because we had put in the additional capital. It was not necessitated by the acquisition of the Blass building—came

after we put the capital in. The capital was required by the Federal Reserve in our application to, I believe—to acquire a mortgage Company, L. E. Lay. That not only required us to put in additional capital of Worthen but the First National Bank of Hot Springs was required to raise additional capital which they did.

Q. Where did the capital come from? A. FABCO borrowed the $5 million on a term loan from the Chemical Bank of New York. That was the purpose of the equity offering was to repay that term loan to Chemical Bank.

Q. Would you refer, please, sir, to Defendant's Exhibits 14 and 15? Also, No. 13, which is a letter by Mr. Gates, I believe, to the law firm of Rose, Meek, House, Barron, Nash and Williamson at that time.

[315] In Exhibit No. 13, Mr. Gates is asking for legal advice with regard to the creation of a subsidiary corporation to own the proposed bank building and a leaseback and what the effects would be, and the response is in Defendant's Exhibit No. 14.

The Court: What are the dates of those? What is 13?

Mr. Sayre: Thirteen is September 21, 1966 and fourteen is October 13, 1966.

The Court: All right.

By Mr. Sayre:

Q. One of the questions that was addressed in this letter was "What would be the tax result or the tax consequences —" This is Defendant's Exhibit 14. "—of the proposed creation of a subsidiary to hold the property and then a rental from that subsidiary?" The response of Mr. Meek was to the effect that it would probably be disregarded by the Internal Revenue Service. Is that basically—— A. I can't recall from memory what Mr. Meek recommended.

Q. This is on page two under the heading Roman numeral one "Income Tax Consequences": "The Treasury Depart-

ment would take the position so far as the tax consequences are concerned that the bank is obtaining a loan on the building and would disregard the fact that the title is vested in the subsidiary and that the loan is being obtained by the subsidiary. The [316] Treasury Department would treat the lease contract held by the lendor or assignee of the subsidiary as being in reality a security agreement. Therefore, the Treasury Department would do the following with respect to the liability:"

He sets forth the bank could not deduct the rentals for tax purposes; the bank could, however, claim a deduction for the portion of the rental payment allowable on interest and also, No. 3, the depreciation; and that no capital gain or loss could be realized on the transfer.

He then cited several authorities which were attached to that letter, one a law review article dealing with—I think out of the banker's magazine—dealing with sales and leasebacks and also a copy of a letter ruling from the Internal Revenue Service to another bank.

In 1966, then, the bank was aware that there existed a possibility or a probability of a disregarding of the sale and leaseback arrangements if a subsidiary corporation was used as the owner or holder of the building; is that correct? A. Well, I think the first paragraph pretty much distinguishes the difference when the first premise was that the bank would create a wholly-owned subsidiary having a rather nominal capitalization. The steps we proposed to take, it would not have a nominal capitalization. I think this letter was an effort on the part of Mr. Gates in exploring all possibilities to find out what areas we should look further in and what areas would be precluded to us.

[317]Q. And that was as early as September of 1966? A. Yes.

Q. If you will refer to Defendant's Exhibit No. 15, which is a letter from the same law firm but Mr. Giroir this

time dated September 8, 1967, and it's to the Worthen Bank——

The Court: What is the date again. I missed that.

By Mr. Sayre:

Q. September 8, 1967. This in line with the plaintiff's Exhibits, correspondence between you as the president of the bank and the regulatory agencies was at the same period of time you were discussing matters back and forth with the Federal Reserve and State Banking Commissioner; is that correct? A. Yes, that's correct.

Q. And the bank then had requested a legal opinion with regard to the ultimate financing that was planned or that was actually used; is that correct? A. That's correct.

Q. And the legal opinion rendered states that they believe the law firm gives you the opinion in their opinion that it would be a viable transaction.

And then on page number six there is—and seven—there is a description of what the position of the bank would be should the Internal Revenue Service disregard the transaction and treat it simply as being—the bank being the owner of the building. It sets forth that the depreciation and the [318] interest would be allowed.

Now since—excuse me. The bank did receive this opinion; is that correct? A. I assume they did. I'm not personally acquainted with——

Q. It came from the bank's file you produced pursuant to the subpoena so it is contained in the bank's records? A. Yes.

Q. Since the questioning of this arrangement by the Internal Revenue Service, the rental deduction claimed by the bank has been disallowed; is that correct? A. Yes, sir.

Q. And in its stead the bank has been allowed a deduction for depreciation and the interest paid on the financing

to New York Life; is that correct? A. I'm not personally familiar with what adjustments have been made on the statement, on the tax statement.

Q. You said you don't know whether or not that depreciation has been allowed? A. I do not know.

The Court: Are you saying, Mr. Sayre, that since the controversy arose the bank has been deducting—depreciating the building on the tax returns and deducting interest?

Mr. Sayre: No, Your Honor. I believe the bank has continued to treat the transaction as it was treated originally, [319] but what I was trying to establish is the position taken by the Internal Revenue Service has been to allow the bank the depreciation and the interest deductions. not I don't believe in the same amount claimed by Frank Lyon because of the election for double declining balance but the depreciation deductions attributable to the building have been allowed to the bank by the Internal Revenue Service, that an inconsistent position has not been taken by the government.

Mr. Sayre: Refer to Exhibit 16 and 17, please.

The Court: Is this Defendant's Exhibit?

Mr. Sayre: Defendant's Exhibit No. 16 and 17. Defendant's Exhibit No. 16 for identification purposes is a compilation of schedules and memoranda entitled "Financing Methods" and has "confidential" stamped across the front of it, and consists of about ten or twelve pages.

Defendants Exhibit No. 17 is, again, a compilation of schedules and is called "Comparison Owning Building with Sale and Leaseback". I think we can stipulate these came from the records subpoenaed from Mr. Penick.

Is that correct, Mr. Williamson?

Mr. Williamson: Yes.

Mr. Sayre:: From the bank's records.

Mr. Williamson: Your Honor, the bank produced all these records having to do with any phase of this transaction. These did come from the bank's records. I do not know, however, [320] the date of this comparison of owning and the sale and leaseback. I don't know when the comparison was made. It's undated.

By Mr. Sayre:

Q. With regard to Defendant's Exhibit No. 16, there are numerous methods—four, I believe—outlined as to how to finance the structure. This would then have been sometime in the early planning stages that this memorandum was drawn? A. Yes.

Q. And there is following that a series of schedules showing various computations of projections by the bank. There is also in there a proposal entitled "Stephens" which I believe is on about the sixth or seventh page in.

Was that with regard to the Stephens and Eastman Dillon offer? A. Stephens, I'm sure, refers to Stephens, Incorporated, investment banking firm. I cannot say whether that included the Eastman Dillon offer or not.

Q. Following that page there are a series of three pages, I believe, a report to you from Mr. Richard F. Gates. This was the vice president in charge of the finance committee? A. Yes.

Q. And they are dated August 11, 1967, reporting on a trip to New York for financing the new bank structure. They described the negotiations with several investment banking firms, New York Life Insurance Company, and serveral banks. This would [321] have been, again, approximately a month before actual groundbreaking occurred. At the back of those there is a comparison or schedule entitled "Comparison of Financing Methods, Sale and Leaseback, $7.5 million, 25 years." There is a comparison between Stephens, which I take it to be Stephens, Inc.; is that correct? A. Yes.

Q. And that was the Stephens, Inc. and Eastman Dillon by that time? A. I can't say whether Eastman Dillon was in on that one at that time or not.

Q. One of the plaintiff's exhibits is the Eastman Dillon proposal No. 39. A. Well, Eastman Dillon made its own proposal and Stephens made their own, and then they got together. This is undated and I don't know the date of when they got together, so I couldn't say whether they were together at August 11 or not.

Q. Throughout this period you had a firm commitment from Stephens and it says Goldman Sachs was tentative? A. Yes.

Q. I believe—then did Goldman Sachs later or at a subsequent time firm up that offer or make a firm offer? A. Yes, they did.

Q. Now the last page is not very clear but it is a copy on what is originally lined yellow paper with the Worthen [322] stamp on it. It's entitled "$7.5 Million Office Building Investor's Income Assuming Life of Building is 40 Years, Depreciation on Double Declining Balance Basis through—" and it's got 14 year straight line 16th through 25th year.

There follows a series of computations: 25 lines for lease payment income, depreciation, interest paid on mortgage plus interest on balance, net income or loss and accumulated net income or loss.

Was this prepared by the bank as a computation to determine what the maximum tax benefit would be under the double declining balance method of depreciation? A. I can't say from my knowledge why this memorandum was prepared or by whom it was prepared, but I think it was prepared probably to assist us in knowing what we were negotiating against, what was the value to a proposed investor of an investment of this nature and to assist us in our negotiations. But I can't say who did it. I don't recognize the handwriting.

Q. With regard to line number 11, which would indicate the 11th year, there is a maximum benefit under accumulated loss of $1,620,123.30. I believe the last page of Defendant's Exhibit No. 17 is also that same page except there's been a pencil mark on No. 15—or that the 16th year has been scratched out and the 15th put in there and there's been a dot placed alongside the line of number 11 of the maximum loss [323] accumulated.

Was it part of the finance committee's recommendation that an investor be advised that they could enjoy the maximum tax loss or tax shelter by buying your building and depreciating it at a double declining balance method? A. No. We were dealing with sophisticated investors that knew more about this business than we did. One of the reasons that we explored every possibility was that we were in the learning process.

People like Eastman Dillon and Stephen and Goldman Sachs were doing this almost on a daily basis and it was a one-time round for us.

Q. This sheet was prepared on bank's stationary and comes from the bank's records. It was, I think you said, probably prepared to acquaint the finance committee then with what position— A. What position the person on the other side of the table: what were his strengths, how was he dealing. I'm sure he was looking at a schedule such as this.

Q. Now with regard to the proposal that you made in the specifications, Plaintiff's Exhibit No. 13, there is a computation of the repurchase or options exercised at the end of 15 years, and your testimony was that it was calculated, as you recall, because of the Banking Commissioners statement.

On Exhibit No. 14, the next exhibit which is [324] acceptance by Frank Lyon Company of your proposal, in paragraph six of the second page there is a repurchase sum-

mary at the end of the 11th year. Do you recall a discussion or questioning of why that provision was put in the acceptance letter? A. No. I think that the acceptace letter looked like it just recopied what we had put in our specifications.

Q. Basically, it does except for paragraph six refers to repurchase at the 11th year where your letter had repurchased at the 15th year. What I'm asking you is do you recall any conversations with Mr. Lyon or representative of the company as to why the 11th year was inserted on their acceptance of your counterproposal? A. No, I don't recall any reasons for that.

Q. You don't recall any conversation about it? A. No.

Q. And again, it was your testimony that you believe that the "C" part of that subparagraph six "add any premium or deduct any discount" was, again, the difference between the interest factor of six and six and three-quarters percent? A. I believe that's what it was. I didn't calculate it but I think that's what it is.

Q. If you will refer, please, to Plaintiff's Exhibits 45 and 46, I believe—at least 45. This is a schedule "Comparison of Annual Rents with Total Depreciation and Interest for Ten years". It was figured on a straight line basis. May [325] I ask: Did you prepare this exhibit? A. No, sir.

Q. Do you know who did prepare it? A. No, I don't.

Q. So the bank did not prepare or have this exhibit or a similar exhibit when it was entering into the financing of bank structure? A. Not to my knowledge.

Mr. Williamson: Your Honor, this was prepared at my request by Mr. Louis Shuffle, Comptroller of the bank, two or three days ago for use as an exhibit in this case.

The Court: Very well. Let me just interrupt you a moment. It is ten after 12:00. And I don't mind working to see that you make your airplane but on the other hand—

Mr. Sayre: I realize that, Your Honor. I think Mr. Penick is the last witness of any length. I don't want to say in stature, but of any length we are going to have and I would like to—I think I could finish here in another ten minutes at the most probably with my cross examination.

The Court: Very well. On that assumption, we will proceed.

Mr. Giroir: Just a point of clarification. The question you raised a moment ago as to whether Frank Lyon is relieved of liability on the note in the event they exercise the option. I reviewed the option and I don't find any [326] provision for the release.

The Court: I am going to assume that it would not be released in case of the bank's default—that is, Worthen's default. The insurance company could look back to the plaintiff.

All right.

By Mr. Sayre:

Q. Mr. Penick, we have been over the description of how the option price was determined and that an investor would put in 6 percent—excuse me—would put in $500,000.00 and receive six percent on that if and when the option were exercised. I believe you have been in the courtroom and heard the argument or statements of counsel, and the question was asked you on direct examination that the government theory of the case is that, in effect, Mr. Lyon's company has made a $500,000.00 loan at the rate of six percent. And your statement was that you could not understand that under any accounting or tax theories; was that correct? A. That's correct.

Q. You do not understand that the government would treat the $500,000.00 investment of Frank Lyon Company as a loan to the bank to be repaid at six percent interest in accordance with the statement in Plaintiff's Exhibit

No. 13, which is the specifications of the bank if and when the option were exercised? [327] A. I don't understand how the government's theory could say it's a loan. It is clear throughout the specifications treated as an equity investment. No theory of accounting and economics could develop—you'd have to go way far out to develop that equity investment in real estate as a loan.

Q. Or would have to ignore the form of the transaction and consider that in substance it was a loan with a return on that loan of six percent.

The Court: Since we are really arguing for the benefit of the Court—and that's practically what we are doing throughout the trial because essentially most of the facts are undisputed—let's just ignore all form and just try to find out in terms of a loan. A loan of so much money usually requires it be repaid usually at a certain time or usually requires or has incident to it a payement of interest that is required to be paid by the borrower.

Now is there in this transaction, disregarding all substance, any obligation to repay the loan or any obligation to pay the interest—legal obligation that you call interest?

Mr. Sayre: Are you referring to me or the witness?

The Court: We are arguing the case, it seems to me, and I want to get right to it.

By Mr. Sayre:

Q. Mr. Penick, let me ask you if the obligation of the [328] bank would be to pay the option price if the bank exercised the option.

The Court: That's quite clear. I am doing my best to do what you suggested and disregard everything and find out if there is an obligation to repay the so-called loan. Every loan I have ever heard about is that every loan requires at some time it be repaid. Most of them require an interest

rate and that's what the government is saying it is and it is required to be paid at a certain time.

Is there any legal obligation in connection with any of these agreements, however you characterize them, for the repayment of the so-called loan or for the payment of interest that is not dependent entirely upon the exercise of the independent judgment of the bank as to——

Mr. Sayre: I believe they are dependent upon the exercise of the option.

The Court: In other words, if the "lender", Frank Lyon, wants to gets its money back and its interest at any time, how can it do it? Is there any way it can do it legally, force—

Mr. Sayre: On the exercise of the option. That would be the decision of the bank. That's correct.

By Mr. Sayre:

Q. The bank, you said, has not made a decision whether or not the exercise these options; is that correct? [329] A. That's correct.

Q. In other words, the decision of the bank will come at the time each option occurs? A. Yes.

Q. And you stated that under those reports a certain amount of capital would be projected to be needed over the next five years? A. Five years.

Q. And also that the bank in the last two or three years has doubled its capital; is that correct? From— A. Doubled its capital stock, yes. Five to ten million.

Q. So as you describe the bank went outside and got the capital to—from FABCO. FABCO went outside the bank to get the capital? A. Yes.

Q. In a two-year period the bank doubled its capital?

Now in Plaintiff's Exhibit 46 there was a—This is going beyond 25 years, the first 25 years of the loan or the least period covered by the loan, and if all the transactions occur

as stated in the lease and the bank continues to maintain its ten point one percent return, the bank would have a probably or a possible gain of a little over $5 million by not exercising the option; is that correct? A. That's correct.

[330] Assuming the fair market value of the building is about $2 million at that time, two million one.

Now if the inflationary spiral we have been living in over the last few years, the inflation that has occurred in this country, say, for the last 50 to 60 years, and the price—fair market value of the building was, say five to seven million dollars at 25 years from the date, would the bank exercise its option to purchase the building for two million one if it had an asset that it could acquire that was worth two or three times that much? A. Well, I think you'd—it would be mere speculation in trying to look 25 years down the road.

Q. It's mere speculation looking 25 years down the road on this; is that right? A. I think the only thing—this is what we know or we feel we can do. I think the only thing that is speculative here is can we maintain ten point one percent return on capital. That's the only factor in there that's the unknown.

Q. Assuming that the bank building would be worth $5 million and you could buy it for $2.1 million, $2,145,000.00, the bank could exercise the option, purchase the building and then if it didn't want to stay there it could actually sell the building and realize the appreciation in gain or the appreciation in the value, building itself, rather than the Frank Lyon Company recognizing that. [331] A. Yes, it could.

The Court: Aren't you saying, Mr. Sayre, that the bank cannot make, certainly, the best judgment as to what is in its best interest until the last minute?

Mr. Sayre: Until the time the options come due; that's correct.

The Court: And economic circumstances can change materially and alter the basis for a decision that can be predicated at this time?

Mr. Sayre: That is correct, Your Honor.

By Mr. Sayre:

Q. The guaranty or the option to repurchase on Frank Lyon's outside agreement, Plaintiff's Exhibit No. 50, there is an agreement that if Frank Lyon Company is sold that the bank has the right to purchase the building or to find a nominee to purchase the building acceptable to it. Is that the bank's understanding? A. I think this letter is an indication that Frank Lyon will see that the bank's interests are protected and that an owner of the building acceptable to us is made available.

Q. And in other words, a substitution of another company acceptable to the bank for the Frank Lyon Company? A. Yes.

Q. Mr. Lyon has been—is a director? [332] A. Yes.

Q. How long has he been a director of the bank? A. Since 19—mid-1950's. I'd say probably '55.

Q. Approximately 20 years? A. Yes.

Q. Or close to 20 years?

The Worthen Bank guarantees that it will pay all of the rental for the 25 year period. In other words, whether the building is damaged or it can't be used, Worthen Bank has an outstanding obligation with no setoffs to pay that amount of rental; is that correct? A. I'm not that familiar with the total agreement, but I thought——

Q. I believe yesterday when—— A. I think Mr. Cotham testified to that.

Q. Mr. Cotham attested to that. A. Yes.

Q. Those rights are assigned then to New York Life by Frank Lyon Company and all—I think Mr. Dover said yesterday everything was assigned as security to New York Life. So New York Life as the assignee has the right to

collect the rent directly, which is an amount equal to the debt service on that mortgage in the event that they should exercise that option, and Worthen Bank has the obligation to pay that amount for 25 years; is that correct? [333] A. Yes.

Q. And again——

The Court: I guess to protect your ability to pay and cover the risks you insure as to damage to the facility?

The Witness: Yes.

The Court: Fire and so forth?

The Witness: The lease payments are not insured, Your Honor.

The Court: No. I understand that.

The Witness: Physical facilities are.

The Court: Is there any protection to you against condemnation?

The Witness: There are condemnation clauses in the provisions.

Mr. Sayre: Provision 18, Your Honor, or paragraph 18 of that provision, 17 or 18. One of them has to do with total destruction and the other one——

Mr. Giroir: Condemnation provisions roughly parallel the damage construction provision. The condemnation award being set off——

The Court: There is no way in which you would be looking to the constitution, in effect, to protect you in terms of the fair compensation as to these obligation?

Mr. Giroir: Yes, sir.

The Court: You can't really insure any other way [334] against condemnation, can you?

Mr. Giroir: We weren't able to arrive at that.

By Mr. Sayre:

Q. Now the financing was arranged by the Worthen Bank and this investor was sought. The bank has retained control of the building, not only in its inception and planning its construction, but also in the actual use of the building; is that correct? A. Yes. We rent the whole building and subrent it.

Q. And all rights of the bank and the Frank Lyon Company under these numerous agreements have been assigned to the ultimate mortgage holder, the New York Life Insurance Company. A. Yes.

Q. And if there is any problem with the bank building, any suit brought, any damage to the building by natural or fire causes or if any other risk attendant to that building is borne by the Worthen Bank; is that correct? A. I think you will probably find Frank Lyon Company joined if there was some suit brought that related to the ownership of the building.

Q. And you have granted them an indemnity against any judgment? A. Arising out of the occupancy and use of the building.

Q. Under the lease. So that, in effect, for the life [335] of that lease the ultimate risk of the operation of the building lies with the Worthen Bank; is that correct? A. Yes, sir.

Mr. Sayre: No further questions, Your Honor.

The Court: And I guess there could be really no net lease unless—to the lessor, unless he was guaranteed more or less against having to assume additional obligation down the line.

The Witness: Yes, sir.

The Court: So this is part of the agreement to protect his expectancy in terms of the undertaking; is that correct?

The Witness: That's correct, plus that's the way we want it. We not only wanted the responsibility, but the authority. It's a two-sided arrangement.

The Court: You may stand down.

Let's see, Mr. Williamson. I am trying to make my plans here. We have Mr. Lyon and who else? An expert?

Mr. Williamson: Yes, sir. I have only two or three questions on redirect so that won't take any time.

The Court: Well, let's just be in recess an hour. I think I can't cut it down more than that.

We will be in recess until 1:30.

(Whereupon, at 12:30 p.m., the above-entitled proceedings were in recess, to reconvene at 1:30 p.m., the afternoon of the same day.)

AFTERNOON SESSION

1:30 p.m.

The Court: Redirect, Mr. Williamson.

REDIRECT EXAMINATION

By Mr. Williamson:

Q. Mr. Penick, I believe the last line of questioning that you were faced with involved government's attempt to establish that in the event of any fire or damage through Act of God down there that it would be Worthen Bank who would bear the economic burden or the loss involved, economic loss.

Would you please state whether or not you have insured against all of these contingencies? A. Yes, sir, we have insured against all contingencies and possibilities that we can insure against.

Q. So in the event of any destruction it would not be Worthen Bank but the insurance company that would bear the economic loss; is this true? A. Yes.

Q. Referring again to Plaintiff's Exhibit No. 50, I believe the government attorney asked you if the purpose of this letter was simply——

The Court: This is Plaintiff's Exhibit 50, is it not?

Mr. Williamson: Plaintiff's Exhibit 50.

The Court: I thought you said Defendant's Exhibit.

[337] By Mr. Williamson:

Q. The purpose of this letter was simply to guarantee Frank Lyon Company that—that Frank Lyon Company was simply going to guarantee to Worthen Bank that they would see that you would get an acceptable owner of the building.

Does it actually do that or would you refer again to the exhibit and state what Frank Lyon Company is really doing? A. Well, I think it is expressing the intention. The letter reads: "I will contact you to see that the bank's interest in having an acceptable owner of the building is protected. Will at that time sell the building to you or your nominee at a price which we will negotiate."

Q. And the method of protection was to sell the building to Frank Lyon Company at a negotiated price? A. Sell the building to either an acceptable owner, I believe.

Q. Or you? A. Or us.

Q. At a negotiated price? A. Yes.

Q. Can you also on cross examination, as attempted to be brought out, that it was Worthen Bank who had first picked the option to purchase as ending at the end of the 11th year. Can you refer to Plaintiff's Exhibit No. 12 and indicate [338] whether or not—from whom the idea of the 11th year option came? A. It came from Stephens, Incorporated in a comparison of the proposals that had been submitted by Goldman Sachs, Stephens and Frank Lyon.

In the Frank Lyon Company proposal it was a repurchase only at the end of the 15th year.

Q. And in Goldman Sachs they have suggested the 15th and 20th years, I believe. A. Yes, sir. I think that I testified earlier that what we did in trying to write our specifications were to pick the items of each of these proposals that were most beneficial to the bank and, of course, the option ran entirely in our favor and it would have been to our benefit to have the right to exercise that option at an earlier time.

Q. Would you now, please, refer to Defendant's Exhibit 16 and to a schedule about halfway through headed up "Stephens". A. Yes, I have it here.

Q. That schedule, again, took income on December 31, 1966; took balance on June 30, 1967, call. "Stephens had 80 percent occupancy at $4.50 per square foot."

Is that referring to this Worthen Bank Building or could that be some information obtained from Stephens in connection with Stephens' experience on its own Stephens Building? A. I think it's probably some information that they [339] solicited from Stephenson the basis of which they computed their figures.

Q. But those figures had nothing to do with Stephens' bid on this Worthen Bank Building? A. Not to my knowledge.

Q. Also on cross examination it was brought out that the government is contending that in a current examination of Worthen Bank's tax return for 1969 that the government has allowed Worthen Bank a deduction for depreciation on the building and interest paid to New York Life.

Has Worthen Bank contested that determination or agreed to it? A. We have contested it.

Q. One final question.

You referred in cross examination that you had negotiated these leases—I mean these loans on both interim and permanent financing in order to get the best rates that you could because "We would be paying the interest."

By that, just what did you mean? A. Well, we would be paying it indirectly in the form of rent over the term of the loan.

Mr. Williamson: No further questions.

RECROSS EXAMINATION

By Mr. Sayre:

Q. With regard to that last question I asked you to [340] at Defendant's Exhibit No. 11 and 12. Defendant's Exhibit No. 11 is a copy of a letter written on the stationery of the bank and signed by Mr. Frank T. McGehoe.

Who is he, please, sir? A. He was the building coordinator.

Q. It is dated November 28, 1969 to the New York Life Insurance Company. It says: "Attention Vice President, Real Estate and Mortgage Loans" and it refers, of course, to this building transaction.

"This is to certify to New York Life Insurance Company that as of October 31, 1969 the records of Worthen Bank and Trust Company show that it has paid in connection with the total cost of the mortgage property as defined in paragraph 2E of the consent and agreement dated May 1, 1968 between Worthen Bank and Trust Company and the New York Life Insurance Company as follows:"

There is a breakdown of the payment to Matson Bellows, architectural fees, construction consulting fees, interior design consulting fees, so forth. Under "other material"—on the last page it's got "legal and accounting fees and interim interest on construction funds borrowed".

Do those construction funds of $399,000.00 pertain to money borrowed on the building itself? A. I would assume that they do. I'm not exactly familiar with it.

[341] Q. If the testimony has been that Frank Lyon Company has paid—drawn the money down and paid it,

why would the bank certify in this letter to New York Life in accord with the agreement and—consent and agreement which is an exhibit here—that it had paid this interim interest? A. Well, I think this letter dealt with the requirement of the New York Life Insurance Company in the final closing and certification from us as to exactly the total cost that had gone into the building.

Q. Then what you are saying is that—— A. I think it is a mistake in the way it is written because the total cost in the building and these—the interim construction loan ran to the Frank Lyon Company.

Q. Now we talked about the interest was arranged, or the terms of the loans were arranged by Worthen Bank prior to the time that even Frank Lyon Company, had got into this arrangement. Because you said the bank would be paying the interest indirectly through the rent; is that correct? A. Right.

Q. What about the same agreement was made with regard to the interim interest, the interest on the interim loan? A. I'm not sure whether we paid the interest on the interim loans or not. We did not. I'm——

Q. Then the total amount of miscellaneous expenses claimed with regard to the building: this is fees of the [342] accountant and attorneys under the various agreements and the claim for interim interest to Frank Lyon, approximates $500,000.00.

Was it contemplated that the $500,000.00 that Frank Lyon was going to put into the venture would cover expenses? A. No. There was no inter-relation between those two at all.

Q. It's just coincidence? A. If it turned out that way it is coincidence.

Q. And on Exhibit No. 12, which is the independent certified accounting firm of Cotham, Wyman and Howland also certifying to New York Life that the interim interest on the construction loans were paid, that was, again—it was

not paid by Worthen Bank and that is a mistake in the certification? A. Well, I don't know exactly how the books were handled on that. These certificates were not so much how they were paid but what the total cost went into the building.

Q. You stated that the Worthen Bank had covered its risk, ultimate risk with regard to damage or repair or anything to do with the operation of the building is borne by Worthen Bank rather than Frank Lyon Company; is that correct? A. Through the insurance.

[343] Q. Then the insurance premiums that go into this are paid for by Worthen Bank; is that correct? A. That's correct.

Q. Now you stated that the bank had contested the treatment made by the Internal Revenue Service. Before lunch you said you didn't know what treatment had been made. Have you checked since that time? A. Yes.

Q. The Internal Revenue Service has allowed the bank a depreciation deduction and an interest deduction for the New York Life loan; is that correct? A. I checked on whether or not we had contested it and I have the comptroller of the bank who would speak to that better than I could.

The Court: It is immaterial whether the IRS is being consistent with another taxpayer or not. I am assuming that it is.

Mr. Sayre: I have no further questions, Your Honor.

Mr. Williamson: May I just ask one further question?

FURTHER REDIRECT EXAMINATION

By Mr. Williamson:

Q. Referring again to Defendant's Exhibit 12, prepared by the certified public accountant firm of Cotham, Wyman and Howland, as stated in the letter itself pursuant to paragraph 25 of the consent and agreement, under that

particular [344] agreement, consent and agreement between Worthen Bank and New York Life, that paragraph 2E required the accounting firm to certify as to the total cost of the building, not who paid for it. A. Yes, sir.

Q. And this certificate is being made pursuant to that. A. Total dollar amount that went into the building.

Q. And in showing that the interim interest on construction funds borrowed were paid in the amount of three ninety-nine and legal and accounting fees paid in the amount of $53,000.00, is not a certification that Worthen Bank paid them is it? A. It is not intended to be.

The Court: Did Worthen pay them?

The Witness: Sir?

The Court: Did Worthen pay them?

The Witness: No. Frank Lyon Company paid.

The Court: All you paid Frank Lyon so far is a rent—you call a rent, and the government calls interest. At least it equals the amount of the obligation to the New York Life?

The Witness: Yes, sir.

The Court: And if anything else was paid it was not paid by Worthen?

The Witness: That's right. Yes, sir.

[345] The Court: I am just talking about dollars. I assume these bills were paid by somebody: the interim interest and the legal expenses and the bills, I think it is undisputed they came out of the bank account of the plaintiff, is it not?

Mr. Williamson: That's correct.

The Court: And they weren't indirectly paid in the sense that nothing in excess of the rental payments were paid by Worthen Bank to the plaintiff.

The Witness: This is a requirement by the New York Life Insurance Company as to the total cost of the building. We had to certify as to the total cost of the building, not who paid it.

By Mr. Williamson:

Q. And, of course, Mr. Cotham has already testified that Frank Lyon Company paid for the interim interest monthly out of its own fund? A. Yes, sir.

Q. Consequently, in Defendant's Exhibit No. 11, in which Frank McGhee—would you explain who Frank McGhee was in connection with this project? A. Frank McGhee was the Worthen Bank staff member who carried the responsibility as building coordinator, who coordinated all aspects of the building and to be in charge of renting the building.

Q. As I understand it, the loan agreement also required [346] Worthen Bank to certify as to the cost of the building. A. Yes, sir.

Q. So in this DX 11 in which Frank McGhee is certifying that Worthen paid these costs to the extent that he is certifying that Worthen paid the interim interest and the legal and accounting fees, it is simply an error, is it not? A. Yes, sir.

Q. Really what he should have said is that the total cost of the building was this, not that Worthen paid this amount; is that correct? A. That's correct.

Q. And only to that extent is this certification of McGhee in error? A. Yes.

Mr. Williamson: No further questions.

The Court: All right, Mr. Penick, I think they are going to let you go.

(Witness excused.)

The Court: Call your next witness.

Mr. Williamson: Mr. Cotton Barnes.

The Court: Mr. Barnes, come forward, raise your right hand and be sworn.

Thereupon,

C. V. Barnes

[347] having been called as a witness by and on behalf of plaintiff, and having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

By Mr. Williamson:

Q. Would you please state your name and address? A. C. V. Barnes, 22 Wingate Drive, Little Rock, Arkansas.

Q. How old are you, Mr. Barnes? A. How old am I?

Q. Yes. A. Fifty-seven.

Q. Fifty? A. Seven.

Q. What is your occupation and present employment? A. I'm a realtor, real estate counselor.

Q. How long have you been engaged in the real estate business? A. About 25 years.

Q. With what firm are you presently associated? A. Barnes, Quinn, Flake and Anderson.

Q. What is your position with that firm? A. President.

Q. What higher education did you have after high school years, Mr. Barnes? [348] A. I attended Little Rock Junior College and Oklahoma State College.

Q. How long have you been a real estate appraiser? A. About 20 years.

Q. Of what professional associations are you a member? A. Well, a member of the American Society of Real Estate Counselors. I'm a senior member of the National Association of Independent Fee Appraisers. I belong to the local, state and national association of realtors.

Q. Incidentally, how many members are there in this American Society of Real Estate Counselors? A. There are about 430 members, I believe, nationwide.

Q. How many in Arkansas? A. Four.

Q. Have you in your professional career served as an official appraiser or designated appraiser for any government agencies? A. Veterans Administration, General Services Administration at the federal level. At the state level almost any state—well, that's not literally true—but a whole lot of the state agencies. City of Little Rock, housing authorities of both Little Rock and North Little Rock.

Q. Have you been appointed in any official position as a member of a federal land commission appointed by Judge Henley? [349] A. Yes, sir, I served as a member of a federal land commission on properties on the Cadron Creek under appointment by Judge Henley several years ago.

Q. Mr. Barnes, without going into any great detail, would you simply explain the more common methods of financing real estate need for someone who wants a building? How would he go about the various methods he would use to meet those needs. A. By financing—I'm assuming you are speaking in the broad generic sense of how you would go about arranging for all of the money necessary, whether by a loan or by other methods.

Q. That is correct. That's what I mean when I talk about financing arrangements. A. Of course, the simplest arrangement would be for an owner to just make a direct mortgage for a part of the money with a balance of the money being equity put up on the part of the owner. That's the simplest form I presume.

But today, particularly on larger type developments, it's unusual to find a development that's done on that simple premise. Generally, they use a multiple of different methods. They will probably start off with a ground lease and then it could—the leasehold could be mortgaged and lessor's interest could be mortgaged. You can just take it about as many steps as you want to take it.

[350] Q. What generally dictates the particular form in which a financing of a real estate venture occurs? A. The form that's most favorable to the developer.

Q. Is it unique in real estate investment that a potential tenant would want to build himself a facility and then sell it and lease it back? A. No, sir. Particularly among national concerns this is probably more nearly the pattern than the other way around. People like Safeway stores, IBM and other national concerns will get the control of the property, build the property, may or may not arrange for the financing—some do and some don't—and then when it's all said and done sell it and lease it back or have a prearranged agreement before they do it to sell it and lease it back.

But the main thing is that anyone like that wants to keep control of the development all the way through.

Q. Why does he want to keep control of the development? A. Well, he wants to keep control of the development because he's going to be the user of the property and he wants to be assured that what—the end result meets his needs.

Q. But then when he sells the property, does this mean that he hasn't really disposed of the ownership even though he may lease it back?

[351] Mr. Sayre: I object to that. It is a legal determination.

The Court: I think the objection is proper.

By Mr. Williamson:

Q. Mr. Barnes, you mentioned Safeway as a national concern that frequently uses a sale leaseback. Are you familiar with the Safeway sale leaseback forms? A. Yes, sir.

Q. Have you ever been involved in any sale leaseback transaction representing the property owner in your own experience? A. Yes, sir.

Q. The plaintiff has already introduced as exhibits in this case a particular transaction involving a T. M. Mayer and Safeway. Is that his name? A. It's Teddy Mayer and Nick Mayer.

Q. Without going into any great detail in that transaction, would you explain who the Mayers were and just how the transaction developed and what the terms were? A. Well, the Mayers are—well, I should say, I guess, were local residents of Little Rock. One of them has since moved outside the city. They owned property at Markham and Rodney Parham Road. They retained me as their agent to see about leasing the property. I made a ground lease with Safeway Stores and with Magic Mart. Safeway Stores, after [352] executing a ground lease——

Q. Just briefly, what were the terms of the ground lease?

Mr. Sayre: Again, I'm going to object as I did at the start to the introduction of the specific document into evidence and the testimony about the specific transactions which has nothing to do with our transaction under the sale and leaseback. He obviously is a realtor and an expert as a realtor. If he has knowledge generally, he can testify, but I don't think as to specific transactions that they have anything to do with the specific terms that we have here and, therefore, it is immaterial to this action.

Mr. Williamson: Your Honor, I think it is material for this reason: Safeway is one of the pioneers in this whole field of sale leaseback. This arrangement he has is a typical Safeway—they call their program buy, build, sale and lease program. They had a whole setup for this. It parallels this situation almost exactly and I would like to show that this is a very widely used device and well known to all realtors of a type of financing which is recognized by the government as a true sale leaseback.

The government allows Safeway the rental deduction. It allows the investor the depreciation and the deduction for the depreciation. It is just simply a typical sale leaseback transaction in the general real estate trade and then draw [353] parallels between that situation and this, which are

almost identical on the face of it except for the dollars involved.

Mr. Sayre: Your Honor, we have not had any evidence or testimony of whether or not Safeway leases have been challenged by the Internal Revenue Service. We'd be more than willing to stipulate that sales and leasebacks are ways of financing construction and in the letter I believe of Eastman Dillon which is in evidence, they have stated they have placed "X" million dollars in sale and leaseback financing, but I don't think any particular transaction with regard to a Safeway store here in Little Rock has anything to do with the issue in the suit with regard to this particular taxpayer as the cases have shown which both plaintiff and defendant have cited. The facts in each one vary and are slightly different.

I don't think this Safeway transaction, which to my understanding was never even culminated——

Mr. Williamson: It was culminated, Your Honor, and the testimony will bring this out.

The Court: Of course, I think the objection really is well taken. Whether or not this type of transaction has been used by others, whether or not the government has accepted it would not prevent them from challenging it. Of course, the Court is very much interested in what there is in the usual situation that satisfies the government and how this [354] one differs-and makes it unsatisfactory.

I am going to receive it subject to the objection because I want to inquire of him as an expert as to certain elements, see if I can find out the critical elements that are involved for tax purposes. So I will receive it subject to the objection.

By Mr. Williamson:

Q. Now you say Mr. Mayer first entered into a ground lease with Safeway? A. Yes, sir.

Q. Did Safeway first try to buy the land? A. Yes, sir. It was not for sale.

Q. So Safeway leased it and for what period of time? A. I'd have to refer to the lease. As I recall, the lease option covers 65 years.

Q. You can give him Plaintiff's Exhibit 47. A. The original term was for 20 years.

Q. And how many renewal options were there? A. Six, five-year ones, if I remember right.

Q. And did Safeway have the right to construct a building? A. Yes, sir.

Q. What provision was made with reference to any right of first refusal if Mayer wanted to sell the land or first refusal if Safeway wanted to sell the building? [355] A. They each had refusal options of the other.

Q. Well, the Safeway then proceeded to build the building. Was it the practice of Safeway to sell these buildings? A. Yes, sir.

Q. And pursuant to the right of first refusal, did Safeway offer to sell the built building to Mr. Mayer? A. Yes, sir.

Q. Would you refer to Plaintiff's Exhibit No. 48 and say on what terms was this investment offered to Mr. Mayer? A. Well, in May of 1969 it was tendered on a basis of a nine point four nine constant.

Q. Would you explain just what that means? A. Well, what it meant was that over a 20 year original period Safeway would pay rental equal to point zero nine four nine times the purchase price.

Q. Would you state whether or not it was a net lease? A. It was a net lease.

Q. And by that you mean what? A. That the lessee, Safeway, would pay all expenses. The money received by the lessor would be net. There would be no expenses for him to pay out of his receipts other than income tax.

Q. Now were there any renewal options? [356] A. Yes, sir, they had six, five year renewal options at a constant of three percent.

Q. That is the annual rent would be three percent of the sale price? A. Three percent of the original sale price, correct.

Q. Were there any options to purchase the property? A. Options to purchase?

Q. Or cancel the lease. A. Well, in the event that Safeway should abandon operation of the store, Safeway would have the option to purchase the property back. A. What what was the option price? A. The unamortized—in effect, this zero nine four nine being a constant is set up to return the purchase price plus a rate of return on the money.

Q. And what was that? A. The repurchase price was the unamortized portion based on that constant.

Q. Did you look into that proposal and attempt to advise Mr. Mayer on whether or not he ought to make this investment? A. I did.

Q. And in advising him, what computations did you make? A. Well, I made an analysis based on what the after [357] tax effect would be of making this transaction. My advice was that at that time the lease that he should sell it on was a ten point zero four constant.

Q. Then so he refused this offer? A. That's right.

Q. Refer now to Plaintiff's Exhibit 49. Would you state what happened with reference to the property? Was Safeway able to sell the property on the original terms? A. No, sir, not on the terms that were tendered in 1969.

Q. What happened in July of '71? A. Well, in July of 1971 we were advised that Safeway did have a buyer for the property on somewhat the same terms as the original in that there would be an original term of 20 years with renewal options at a constant of ten point two five.

Q. As opposed to the original proposed rent of what? A. The original proposal was nine point four nine.

Q. And what about the rental during the renewal option period? A. The renewal option period in the '71 proposal was a five percent as opposed to three percent originally.

Q. Did this proposal also contain an option to cancel the lease should the buyer want to abandon that site—— A. Yes, sir.

Q. —and purchase it? [358] A. It had an option so that Safeway could repurchase the property.

Q. And at what price? A. It was, again, on a schedule based on amortization of the purchase price.

Q. Incidentally, this is the original cost of the building, amortization of the original? A. Well, the proposed sale price in both instances is $235,000.00 which was Safeway's initial cost in the property.

Q. Just in the building excluding the land? A. Building and other improvements built on the land.

Q. Did you again make an analysis of this particular proposal? A. Yes, sir.

Q. And in connection with the analysis, did you figure —how did you treat the depreciation insofar as an investor was concerned in figuring the income strength? A. Well, again, I analyzed it on an after tax basis figuring that——

Q. Who would be entitled—— A. —if Mr. Mayer purchased the property or any other investor purchased it from Safeway that they would be the owner of the property and would be entitled under applicable regulations to take depreciation on the property.

[359] Q. Did Mr. Mayer buy this particular property? A. No, sir.

Q. Do you know whether or not it was sold on these terms? A. Yes, sir, it was sold on these terms.

Q. Have you analyzed the transaction and documents in the sale leaseback transaction between Frank Lyon Company and Worthen Bank and Trust Company? A. I have.

Q. Did you see anything unusual in a sale leaseback arrangement and the fact that the bank in this particular case selected the architect and the contractor, the building con-

sultant and supervised the building of the building? A. Nothing at all unusual.

Q. Are you aware of other national concerns, even other than Safeway, who enter into this type of transaction? A. Well, I think IBM does it. Other banks in Little Rock have done it. Not in the case of a sale leaseback, but they have controlled the situation where other forms of quote, unquote financing have been used like limited partnerships and things of that kind.

Q. Incidentally, did you put together the financing in our term of the financing arrangements of First National Bank Building that's going up almost next door here? A. Together with my associates, yes, sir.

[360] Q. In that particular case, would you briefly explain without going into details and vis-a-vis this particular point who the owner is going to be and who actually did all of the work in connection with employment of contractors and so forth? A. Well, in effect, the bank has been in full control of the operation from its inception. We have served as their agent in first acquiring options on the property to get control of it and ultimately purchasing the property; and the bank has, in effect, let the contracts with the architects, the contractors and the other people involved in the transaction. The bank itself will not be the owner of the property.

Q. Who will be the owner? A. A joint venture between a wholly-owned subsidiary of the bank and the National Insurance Company.

Q. And is the bank a member—is this going to be a limited partnership? A. Yes, it is a limited partnership.

Q. Who was the general partner in the partnership? A. Well, the general partner is the First National Building Company which is a wholly-owned subsidiary of the bank and Martin H. Morgan, an individual residing in Dallas, Texas.

Q. Is there any financial strength in the general [361] partner, generally speaking, of any substantial amount? A. Well, the subsidiary corporation of the bank has no substantial financial strength and in considering the size of the project the other general partner's net worth would be insignificant compared to the size of the project.

Q. Is the bank itself one of the limited partners? A. Yes, sir.

Q. Together with? A. Connecticut Mutual Insurance Company.

Q. And in that particular situation the bank made all the arrangements with reference to the contractor?

The Court: I think really to avoid the continuing objection, which is well taken by the government, let's just talk about arrangements in general as opposed to any particular one.

You have mentioned your experience with big companies: IBM, the bank, Safeway and so forth. I am trying to find out the characteristics of these arrangements. Is it characteristic that the developer is the one who contemplates having the future use of the facility?

The Witness: Not in all cases, Your Honor. Some people are the principal users and other cases the development is handled by a entrepreneur.

The Court: Who initiates the projects?

The Witness: Basically the project is initiated by [362] the—by whoever is the ultimate user.

The Court: Someone wants an office building or Safeway store or bank building——

The Witness: Yes, sir.

The Court: Now who controls the design, the architecture and decides on those issues?

The Witness: The user. The ultimate user.

The Court: Is it unusual or typical that the arrangements, in effect, that the lessor is on a net basis and does not incur any obligation with respect to maintenance, repair, management, operations of the property?

The Witness: In the typical sale leaseback, a net deal is by far predominant. There may be a few old ones not on a net basis, but in the last five or six years I haven't heard of one being made on anything other than a net basis.

The Court: More or less looked at it from the developer. Now from the point of view of the lessor, what are the considerations? What is he looking for?

The Witness: Well, he's looking for a facility tailor-made to meet his requirements without any investment of capital.

The Court: Well, are you still thinking—I'm not talking about the investor. The man that owns the land or the one who, in effect, leases it and has on a net basis, what is he looking for?

The Witness: You are talking about the user of the [363] property?

The Court: No, I am not talking about the user.

The Witness: The lessor?

The Court: What is he looking for out of this arrangement?

The Witness: He is looking for what he gets to put in his pocket after taxes and everything is all over with.

The Court: You were talking in terms of a rate of a percentage return on his investment; is that correct?

The Witness: Well, the figure that I gave in connection with the Safeway property is a constant which returns the capital and a rate of return. That's what an investor looks for.

The Court: Is there a difference in terms of the incentive for an investor to buy into this type of arrangement depending upon his own tax situation and his other income? Would this be equally advantageous to any other investor?

The Witness: No, sir.

The Court: So are you saying then that the total economic effect depends upon his own tax situation?

The Witness: That's correct. Under the tax laws as I understand they currently exist, a taxpayer in what we call the lower bracket does not have the incentive to invest in real estate that a taxpayer has who is in a higher bracket.

The Court: Now you have looked at these documents [364] in this case and let's say you were advising Mr. Lyon's company as to whether or not it should get into this transaction and you know the date of the transaction?

The Witness: Yeah, I think I do.

The Court: How would you analyze it for him?

The Witness: Well, I would be analyzing it on the basis of yield on his equity investment on an after tax basis.

In other words, if he is going to invest one dollar equity, what is his return going to be on that one dollar after taxes.

The Court: Do you know of any situation where the investor in this situation would enter it where he had the potential under the agreement to lose money?

The Witness: To lose money?

The Court: Yes. Where he would assume any risk loss.

The Witness: Well, I think that—I don't know of any real estate investment where there isn't a degree of risk involved and there is no guarantee that you're not going

—there's no guarantee of a profit—let's put it that way—in any real estate investment I know of.

Now the type deal Mr. Lyon and Worthen made is the type that has less risk and for that reason the rate of return, so to speak, will be less than on an investment that has a [365] high rate of risk.

Real estate is like other type of investment. The rate of return is relative to the risk.

The Court: Now most of these transactions you have described and this one here has in it several options on the part of, in effect, the lessee to buy at certain periods of time down the line.

The Witness: Yes, sir.

The Court: If they exercise those options that changes —potentially could change the economic advantage to the investor.

The Witness: When you analyze a property for this investor you analyze it based on what happens if the lessee exercises his option at whatever point in time the options are and say, "If he exercises this year your rate of return will be this much. If he exercises this year your rate of return right on down the line. If he does not exercise it here is your rate of return."

The Court: I suppose you start that discussion by saying assuming the solvency of the lessee, the least you can make on this arrangement is blank dollars?

The Witness: Well, that's correct. In a case of this particular deal where you have a fixed rental, it's not too hard to analyze. Sometimes they have—well, Safeway deals, for example, sometimes have percentage rents where you [366] can't predict was that is, but when you analyze it on the basis of what is the best you can hope to do and what is the least you can hope to do. To some extent you would do that

in a case like the one between Worthen and Lyon. Looking on down the road as to what might happen, here's the best you might hope to do; here's the worst you might hope to do. You let the client pick the point in between.

The Court: In this particular case there is the feature that the rental payments by Worthen happen to exactly equal the amount necessary to discharge the obligations to the primary lender, to New York Life.

In your experience, do you recall any agreements where investor has been willing to invest on such terms?

The Witness: I can't cite you a specific local example but it's not unusual.

The Court: All right. You may continue.

By Mr. Williamson:

Q. In determining how much before tax cash flow, does the amount of the equity invested by the investor have anything to do with what the before tax cash flow—what before tax cash flow he might expect? A. I don't know of very many investors who are really concerned about before tax cash flow. What they are interested in is after tax cash flow.

Q. If his equity investment is very low, it is not [367] unusual for there to be no positive cash flow before taxes. A. Irrespective of the equity, it's not unusual in different types of transactions for there to be no before tax cash flow. A good example are the 236 projects, housing projects, permitted under the statute by the federal government for low cost housing. The ones that I have analyzed for clients, I have yet to find one that has a before tax cash flow.

Q. And what about the prospect of the investor never getting his principal back in those investments? A. Well, again the only way that an investor in those 236's gets any return at all is from the favorable tax regulations which permit accelerated depreciation, and so on and so forth.

Q. Now looking at the actual rent that was paid in this case, which did equal exact amount of the payment to amortize the permanent loan over a 25 year period, would you, please, speak to whether or not in your opinion those dollar amounts paid in this particular case were reasonable rent? A. In my opinion the lease rental specified was a reasonable rent for the property.

Q. And would you develop that a little further as to how it came out, how you figured this? A. Well, according to my analysis, the first 11 years of the lease the rental was a net rent of two dollars and 67 [368] cents a square foot, and the last 14 years of the primary term, the rental was two dollars 81 cents per square foot. But, of course, that is a net rental, number one. Number two, it is for the entire building, no exceptions with a hundred percent rental, no vacancy or presumably no credit losses.

If you add to that the cost of operation for a building of that type, taxes, insurances, housekeeping and all of the types of things which would figure two dollars to two and a quarter a square foot, then the square foot rental rates relates favorably to the rental rates being charged in other comparable office buildings.

The Court: Maybe you can just tell me without proof in this case. The building that the plaintiff owned and leased to Worthen was not finished for tenants, was it, in the sense that I got the drift of the testimony, at least, it might not have been partitions in the rental spaces, and this would be something Worthen would work out and subleases with its own tenants. Am I correct or not? Was it finished in the sense that all the offices and all the spaces in the building were ready for rental to someone else?

Mr. Williamson: It was finished in the sense that it had walls up, partitions and so on, but it did not—if someone wanted walnut paneling or any special built-in desk, table or so forth, it was not finished. This would be, again, in

connection with the negotiations with the tenant. Worthen [369] may do that or the tenant may do that. It may be leasehold improvements of the tenant himself, depending on the amount of rent the subtenant would pay.

The Court: Were partitions there before you had a tenant?

Mr. Sayre: I think with regard to that, what you are asking is whether or not the building was completed and walled on the inside as it went up. The leasehold improvements that the bank put in of a million and a half dollars or so was done contemporaneously with the outside of the building so when completed you didn't have to go back and put the floors in. It was done contemporaneously with the shell of the building.

Mr. Giroir: The building was completed on an exterior and interior outside walls, and the flooring structure was completed; but the particular type of floor and the particular type of partition and any other of the interior improvements were only constructed as needed. Obviously, the lower floors that were to be utilized by the banks were completed first and almost simultaneously with the completion of the building. Thereafter, it was more or less a shell building.

The Court: So what Frank Lyon Company was leasing to Worthen was essentially a shell?

Mr. Giroir: With all the mechanical, electrical [370] and structural components, but not the interior.

Mr. Sayre: Since there is some dispute, may we recall Mr. Penick to clear that up?

The Court: If it does turn out there is any dispute. I was trying to make it with relation to Mr. Barnes' testimony as to what a reasonable rental would be on the local market. I wanted to know what he was renting, what he was thinking about.

Let me ask: Mr. Penick has been under oath. Just stand right there and tell me now. I know you put over a million dollars in terms of improvements in this. Are those improvements not only improvements of the facilities that the bank uses and the floors and lease space the bank uses, but also facilities that you have made for your own tenants at their requests and as part of your arrangements with them?

Mr. Penick: Yes, sir, which would be recaptured in the rent from the tenant. If a tenant was going to lease a whole floor, he had certain tenant allowances. He could have a certain quality of carpet, certain type of paneling. We would pay for so many lineal feet of partitions. Anything over that, he would have to pay for. For example, one tenant wanted a floor and a half and wanted to join the floors by an interior stairwell. They paid for that by an increase in rent and that went onto our books as leasehold improvements, which we will recapture in the rent to the particular tenants.

[371] The Court: What did you rent from the Frank Lyon Company? Before you spent any of the million plus money on the building, what did you have?

Mr. Pennick: Certified in that list about a total in our building of $7.6 million, which was a functional building: exterior walls, lights, heating and airconditioning, but not detailed tenant improvements except in some of the areas we were occupying. Basically, it was $7.6 million bank building and high-rise building.

Mr. Sayre: Mr. Penick, with regard—you said at the time you got to move in, ready to move in, it was 90 percent leased or committed; is that correct?

Mr. Penick: Letters of intent.

Mr. Sayre: At that time did people start moving into the building about the time you did?

Mr. Penick: No. I would say they started moving in two or three months after.

Mr. Sayre: This would have been in January or February?

Mr. Penick: Of 1970.

Mr. Sayre: At that time their spaces were starting to become available. In other words, partitions had been put in, their rug, and this type of thing?

Mr. Penick: Yes.

Mr. Sayre: A short delay before——

[372] Mr. Penick: Two to six months.

Mr. Sayre: How long was it before your building was rented to the point you are talking about, the 90 percent or the initial rent period? How long did it take to get the tenants in?

Mr. Penick: By mid-1970.

Mr. Sayre: Six months?

Mr. Penick: Yes.

The Court: I think my contention was right in the beginning as to what the Lyon Company is leasing to Worthen.

Do you understand what it is that they are leasing when you are calculating these rents, Mr. Barnes?

The Witness: I think I do, yes, but, Judge, let me say this: Again, this is a general practice in the industry. When you make a lease or sale leaseback you have to have some number on which the negotiations take place over. It's very common in build-to-suit property for the parties to agree on a dollar figure and then for the lessee to pick up any additional expense in the form of leasehold improvements.

The Court: All right.

By Mr. Williamson:

Q. And in the light of those facts that have just been disclosed through the question and answer period, is it still your opinion that the rent being paid by Worthen Bank to Frank [373] Lyon Company for the property they were renting was a reasonable rent? A. Yes, sir.

Q. In the light of the then market? A. Yes, sir.

Q. Some discussion has come up with respect to the ground lease only $50.00 a year for the first 25 years. Do you consider this unusual? A. Well, if the ground rent had been a fair market rental it would just have meant they would have had to increase the rental on the leaseback.

Q. Turning now to the option prices, would you comment on what percentage the various option prices were at the various option periods, what percentage of total cost, and whether or not in your opinion these were unusual in these types of transactions? A. Well, the 1980 option was at 82.79 percent.

Q. Of the cost? A. Of the original acquisition cost.

The Court: What transaction are you talking about?

The Witness: We are talking about the option price at which Worthen may repurchase the property.

The Court: All right.

The Witness: In 1980 they have the option to repurchase at 82.79 percent of the purchase price. In 1984 [374] it's 71.11 percent; in 1989 at 54.81 percent and in 1994 at 28.09 percent. Those periods are 11, 15, 20 and 25 years after the inception date of the transaction.

By Mr. Williamson:

Q. Would you comment as to whether or not there is anything unusual about those particular option prices? A. I don't believe there are.

Q. Is this type of way in estimating option prices usual in transactions of this sort? Are these out of line with the

usual sale and leaseback transaction? A. Not in my opinion, no, sir.

Q. Is there any way to accurately estimate the fair market value of just the building now, not counting the land which is not involved here, 25 years from now? A. Well, of course, presumably that's possibly what they were trying to do when they set these option prices I'm sure. Of course, when you get to talking about what something is going to be worth 25 years from now, are you going to be talking in 1968 dollars or are you talking in 1974 dollars or are you talking in 1994 dollars?

I mean, you know, how do you define it?

Q. What would be the various considerations that would go into considering what might be the value of that Worthen Building 25 years from now vis-a-vis obsolescence? A. Well, I think the principal thing that would go into [375] determining its value at that time, 1994, 20 years from now, is its functional obsolescence, not its physical situation.

I know in my lifetime I have seen three of the downtown banks move three times, all three of them—well, will be when First National moves. And also in my lifetime observing the office buildings in the community, surely the Boyle Building down here at Fifth and Main was built right after the turn of the century, but by the same token those buildings that were built about that time after they were some 25 or 30 years old they had to have extensive money spent on them to cure a physical problem, and certain functional problems you couldn't cure. So the result is that that type of age building rents for less money, which results in the value being less than it would if you could rent it for what a class A building would rent for.

Q. Is there anything unusual in your experience that the parking facility next to an office building would be under a different ownership than the office building itself? A. Some are and some aren't. In fact, I'd say there is

only one in Little Rock, I guess, where it is the same ownership and that's the Union Bank Building. The old Worthen Bank property, they did not own the parking deck behind it. The parking deck that was built next to the Tower Building. Of course, in this particular case there is an actual difference in ownership [376] although the property is under the control of the same owner.

Q. From the point of view of a real estate investment counselor and looking at these documents and knowing the transaction as you do, in advising an investor, who would you consider to be the owner of the building?

Mr. Sayre: I renew my objection.

The Court: I will sustain the objection.

By Mr. Williamson:

Q. Let me ask you this question: If this property had been offered to you to find an investor who would enter into this transaction, do you think you would have any difficulty in finding a group of investors who would have bought the building on the same terms? A. I think in 1968 I could have sold the building on the same terms and conditions to a group of investors.

Mr. Williamson: No further questions, Your Honor.

The Court: Mr. Sayre, you may cross examine.

Cross Examination

By Mr. Sayre:

Q. Mr. Barnes, you said you were familiar generally with the financing methods and sale and leasebacks. Have you ever been in on a transaction where sale and leaseback was consummated? A. A consummated deal?

Q. Yes. [377] A. No, sir.

Q. And what were the reasons that you advised the people on the Safeway deal not to get into the transaction?

You said they should not buy it except on a constant of 10.5, something like that, and it was offered on 9.34. A. Rate of return.

Q. Their rate of return would not have been sufficient? A. The rate of return at that time. It ultimately sold at a rate of return that was higher than ten zero four.

Q. And, again, you advised the client not to invest in it at that price because of the rate of return? A. Well, that's right. Now wait a minute. I don't think that's quite right. I think the second time around the client is the one who decided he didn't want to get involved.

Q. The rate of return on the Worthen Building was six and three-quarters; is that correct? A. No, sir. That was the mortgage interest rate.

Q. And the payment of rental which would cover that was exactly the same; is that correct? A. No, sir.

Q. The rental was not equal to the mortgage? A. The rental payments start out less than the mortgage payment, if I remember correctly.

Q. I don't believe you remember correctly.

The Court: The first, five years, I guess you could [378] say that.

The Witness: That's what I had reference to, Judge.

By Mr. Sayre:

Q. What are you referring to? A. As I understand it, the first five years there was $21,000.00 a year less annual rental than the annual debt service on the mortgage.

Q. Have you checked the instrument to see if that was the case? A. Sir? That's the way I read it.

Q. You read the building lease, Plaintiff's Exhibit No. 19, I believe.

The Court: Mr. Sayre, there is no sense in pursuing it. We know what the situation is. The amount is paid, but I don't know it is incorrect for him to so testify. Even at that stage of the record it would not support such a view. The

bank and the representative of the Lyon Company have indicated they acknowledge this obligation as a part of the original transaction so I suppose that is one way of looking at it: that it has the effect of reducing the amounts below the actual amount necessary during the first five years.

By Mr. Sayre:

Q. Mr. Barnes, the original offer of Frank Lyon Company called for a payment of $21,000.00 less than the mortgage [379] payment for the first five years. The New York Life Insurance Company requested and required that the payment be equal to the debt service. The rentals that have been paid are equal to the debt service. On that basis there is no before tax cash flow is that correct? A. On that basis there would be no before tax cash flow; that's correct.

Q. And you said a higher bracket taxpayer would have incentive to get into an investment such as this but not a lower bracket taxpayer; is that correct? A. The higher the bracket the more incentive.

Q. And that being that the main purpose or the main incentive there would be the ability to write off other income from other sources that that individual or company or investor had against those deductions that come from the interest and accelerated depreciation; is that correct? A. I presume so, yes, sir.

Q. In your examination is that the way you would look at is? A. Any higher bracket real estate investor then or now is looking at what he gets to keep after taxes.

Q. And since there's no before tax cash flow, what he's buying then is the shelter; is that correct, of other income? A. He may or may not be depending on the property, yes, [380] sir. It's not at all unusual then or now for an investor to buy "tax shelter".

Q. In this instance the Frank Lyon Company would not receive any before tax cash flow for the first 25 years of this transaction; is that correct? A. I have not made a projection to find out where the point is that it breaks over.

Q. Well, it's quite simple. If the mortgage payment and rental payment are equal for 25 years, there is not going to be any before tax cash flow. A. You are talking about before taxes?

Q. Yes. A. That's correct.

Q. So you are talking about a break-over point is what? A. Before tax cash flow?

Q. You are talking about an after tax cash flow, I presume, when you say you haven't computed the break-over point. A. That's correct; after tax cash flow.

Q. Would that take into consideration using the double declining balance method of depreciation? A. Using any method of depreciation? A. Using any method of depreciation permitted under the regulations and statutes.

Q. Under this type of deal it is normal to use an [381] accelerated amount of depreciation and, therefore, to create the shelter in the earlier years? A. Some investors do and some don't.

Q. In this particular transaction, that was done; is that correct? A. I'm not familiar with what accounting methods they have used to handle this transaction at all. If I were analyzing this or a similar facility for a client, I would probably present my analysis on both an accelerated and a straight line basis.

Q. You just testified that you had examined it and the matter was reasonable and that you would have been able to sell it to anybody else. Did you make your computations based upon the accelerated depreciation? A. As I state, when we analyze a property for a client we analyze it on both an accelerated and a straight line basis.

Q. And you did that here? A. I did not do it on this particular thing in detail, no, sir.

Q. And yet you have testified in your opinion it is a reasonable transaction and that you could have gotten anybody else to buy into it. A. I analyzed it to the extent I deemed necessary to be able to make that statement and I have no reservation about [382] that statement.

Q. What was your analysis and what were the elements of it? A. Well, my analysis would be what the rate of return——

Q. What was your analysis of this transaction that led you to say it's reasonable? A. Well, number one, that basically that it doesn't take any out-of-pocket cash for the deal.

Q. Excuse me. There was no investment by Mr. Lyon? A. Wait a minute. I'm talking about on an annual basis. First you had to put up a half million dollars in equity. Secondly, from then on you didn't put up anything basically, assuming the $21,000.00 a year is a nominal amount compared to the transaction.

Q. How much per year? A. Twenty-one thousand for the first five years. And, in effect, the Worthen Bank would be buying a building for the investor and at the end of 25 years the investor would definitely start beginning to get back additional monies.

Q. Now you said—— A. And this is not—you know, I didn't have to—once looking at that pattern and seeing how it worked, I didn't have to sit down and make a long projection on it to see where the various tax breaks and so on and so forth take place.

[383] Q. So you didn't make that examination? A. No, sir. I did not make that examination.

Q. Now you said, in effect, the Worthen Bank Building is being bought by the Worthen Bank for the investor; is that correct? A. Well, I said that the rent that Worthen is paying Frank Lyon is going to buy the building for Frank Lyon. That's not unusual.

Q. You know there is an option at the end of 25 years to buy the building for two point one forty-five million; is that correct, $2,145,000.00? A. $935.00.

Q. Now do you know how that option price was computed? A. How it was computed?

Q. Yes. A. I understand. I have been told how it was computed. I was not in on the original transaction.

Q. Were you told that the amount is the $500,000.00 at six percent over that period of time? A. Yes, sir, compounded.

Q. Then if the building had a value of, as you said—it amounts to the fluctuation of the dollar amount and it is kind of hard to foresee 25 years into the future as to what dollars are going to be worth. In fact, it is a little hard to see ten years into the future. [384] A. It is today.

Q. With regard to that then, if the value of that building was $5 million in 1994 or 1984, whatever the other is, '89—if the market value of that building was $5 million and the option price was less, the appreciation in value that would usually go to an owner could be taken away from Frank Lyon by the exercise of the option by Worthen Bank and the payment of what is equivalent to six percent on the money for the period of time it was used; is that correct? A. That's correct.

Q. So it would be similar to Frank Lyon loaning Worthen Bank $500,000.00 for the use of that period of time and receiving six percent on it; is that correct? A. No, sir. No, sir. Because there is no assurance that Worthen will exercise——

Q. I said if the option is exercised, it is equivalent of Frank Lyon making a loan to Worthen Bank and receiving six percent on their money; is that correct? A. Well, I don't know. I guess you could look at it that way, but it's not a loan because there is no evidence of indebtedness. What it really amounts to is that in this particular transaction Mr. Lyon was willing to invest his half million dollars in equity for a before tax yield of six percent. Now when you were trying to question me about analysis a minute ago, I was thinking in terms of a detailed [385] year-by-year analysis. I did run through. I don't think I have the figures with me. But I did run through the figures on a half million dollars' equity invested and a six percent return on the half million dollars. And then assuming a 50 percent bracket taxpayer, what the additional return

would be on that half million dollars, I came up with a pretty fantastic figure, if I remember, of a return on a half million dollars after tax of somewhere between 20 and 25 percent.

Q. After tax? A. After tax.

Q. After your depreciation deductions had been taken; is that correct? A. Yes, sir, that's correct.

Q. So in other words—— A. Permitted under the law.

Q. Well, now you are testifying as an expert on the law now? A. No, sir.

Q. Then the use of the tax benefit, accelerated depreciation, is the thing in the transaction that allows a high bracket taxpayer to achieve the incentive to invest; is that correct? A. Well, I think I'd put it another way. The present tax laws and regulations allow a high bracket taxpayer to invest at what sounds like a low before tax rate of return [386] because really what he's looking after is his after tax rate of return. And the higher the bracket he's in the more spread that there is.

Q. And the use of any deduction that he would pick up from that investment against other income; is that correct? A. Against the income from the property and if there is an excess, against other income, yes, sir. Any investor, particularly in this type of property, wouldn't think about analyzing it on anything other than an after tax basis.

Q. What are you referring to as your Section 236 housing? Is this a HUD subsidized loan? A. It's a HUD program commonly called in the industry 236 housing because it's a subsidized rental situation.

Q. Who subsidizes it? A. The government.

Q. What are the characteristics of such a transaction? A. What are the characteristics of it?

Q. That's correct. What does the government subsidize? What do they agree to do? A. Well, the government agrees to make up the difference between a certain level that a renter can afford to pay for rent and the economic rent demanded by the project.

Q. We didn't have the subsidy from the government or anybody else in this transaction we're dealing with between Worthen Bank and Frank Lyon? [387] A. I wasn't referring to the subsidy in the 236. I was referring to the fact 236 projects irrespective of the subsidy—every one that I have had any acquaintance with at all they have been buying quote, unquote tax shelter rather than a 236 project.

Q. The fair market rental of that property on which the bank building stands is worth approximately a hundred thousand dollars a year; is that correct? A. The fair market rental?

Q. Fair rental value of that property on which the bank building stands. A. Oh, the land?

Q. Yes. A. I would estimate that a hundred thousand a year would be probably a fair rental in 1968 for the land.

Q. And you're saying—— A. On a——

Q. That the rental of $50.00, if it had been a fair rental value, would have been rolled back into the transaction? A. I think any sophisticated investor would have added—let's say, if it had been a hundred thousand dollars, they would have added a hundred thousand dollars to Worthen's rent if they had had to pay a hundred thousand dollars in ground rent.

Q. Now you're saying that the fair market value of the [388] option prices was reasonable. Again, it is hard to tell what the values are going to be at any time in the future; is that correct? A. The further in the future it is the harder is is to intelligently analyze it.

Q. And it is your understanding the option prices were computed on the basis of $500,000.00 compounded at six percent; is that correct? A. It is my understanding that the option prices were the unamortized portion of the New York Life loan plus $500,000.00 plus six percent compound interest thereon.

Mr. Sayre: Thank you.

The Court: Mr. Sayre, we are going to have to be in recess here.

We will be in recess until 3:15.

(Recess.)

Mr. Sayre: Your Honor, I have no further questions at this time.

The Court: Are you through with this witness?

Mr. Williamson: Just a couple of questions.

The Court: All right.

REDIRECT EXAMINATION

By Mr. Williamson:

Q. Mr. Barnes, Mr. Sayre asked you a line of questions which suggested that he was under the impression that a [389] constant rate of ten point one that Mr. Meyer was offered on the second Safeway leaseback constituted a ten point one rate of return. Would you explain to the Court whether or not the constant that the investor was getting constituted a rate of return? A. No, sir, the constant is a factor that will return the capital together with a given rate of return.

Q. And the rate of return on a ten point one was actually the rate of return on the investor's equity, assuming the option was exercised, was what? A. I think in that case it was seven and three-quarters.

Q. But it was considerably less than the constant? A. Certainly.

Q. Second, Mr. Sayre asked you that if you assume that the option would be exercised in 25 years and if you assume that the option would be exercised in 25 years and if you assume that at the end of 25 years the value of the

building would be worth $500,000.00, in your opinion is it safe to assume that the Worthen Building would be worth —not $500,000.00—$5 million at the end of 25 years? A. First, the end of 25 years, the property is still subject to a lease. It has options to go for quite a number of years, goes to the year 2044. If you consider the rental rate specified in that lease, you'd probably find it might not even come to $2,145,935.00, if you project the value of that income stream. Of course, you don't know in the year 1994 what [390] the rate of return would be.

Q. So to an outside investor really the fair market value of that building was, in effect—be the income stream from the lease payments over the extended options? A. Right.

Q. And it's been brought out in testimony that from Frank Lyon's point of view, economically it would not make good sense for the Frank Lyon Company to exercise the option. A. For Frank Lyon to——

Q. For Worthen Bank to exercise the option? A. I don't think in 1994 it would be economic for Worthen Bank to exercise the option to purchase, because I think the rental terms on the building there after are favorable to the bank.

Mr. Williamson: No further questions.

RECROSS EXAMINATION

By Mr. Sayre:

Q. Mr. Barnes, I don't think you have answered Mr. Williamson's question as to whether or not the building would be worth $5 million in that year. You said that it's hard to prognosticate 25 years in the future and now 20 years into the future and that it would be in terms of $68.00, $74.00 or $94.00, depending on what you are talking about.

What I was asking was if the bank building had a fair market value of $5 million at that time and appreciation

[391] in value over the 25 year life of the building that would go to Frank Lyon Company. It could be taken away from Frank Lyon Company by Worthen Bank's exercise of that option. If the building was worth $5 million that amount of appreciation could be taken away by Worthen Bank's exercise of the option of a little over $2 million; is that correct? A. Worthen Bank has got the right to exercise that option at those particular points in time whatever the building is worth.

Q. And if it was worth five million, the appreciation Frank Lyon would have realized, had there been no option, would be taken away from them; is that correct? A. What do you mean? He wouldn't have realized any appreciation at that point in time.

Q. That's correct, because— A. No, sir. In the year 1994, which I assume is the point in time we are talking about, the end of the 25 year primary term, the property is still subject to a lease, and the value of the property would be determined as subject to that lease.

Q. No. I don't think it would, Mr. Barnes, in your calculations because that lease would be canceled upon exercise of the option. Is that correct? A. Yes, but you are talking about it having a value of more than that amount. [392] Q. I said if the building had a fair market value of $5 million. We assume that as a fact. Then if the option was not exercised, Frank Lyon Company has testified that they bought it with the hope of building up an equity in the building and having a valuable downtown building.

Now if that building had appreciated in value to the point it was worth $5 million, Worthen Bank could take and exercise their option after 25 years for two million and Worthen Bank would recognize the appreciation in value, not Frank Lyon Company; is that correct? A. Yes.

Mr. Sayre: No further questions.

The Court: You may stand down, Mr. Barnes.

FURTHER REDARECT EXAMINATION

By Mr. Williamson:

Q. One other question right there. If Worthen at the end of 25 years even though the building is worth $5 million, if Worthen Bank wanted to continue to occupy it, would it make sense to Worthen to exercise the option rather than to continue to lease?

Mr. Sayre: Excuse me, Your Honor. I object to him testifying as to what Worthen would do. That's——

The Court: Both of us.

By Mr. Williamson:

Q. Is it reasonable to assume as the government did that [393] the building will be worth $5 million at the end of 25 years? A. Not subject to the lease.

Mr. Williamson: No further questions.

The Court: You may stand down, sir.

(Witness excused.)

The Court: Mr. Williamson.

Mr. Williamson: Plaintiff would like to call as its next witness Mr. Frank Lyon.

The Court: Mr. Lyon, you may testify from the wheelchair, if you wish. You can testify right there.

Please raise your right hand and be sworn. Thereupon,

Frank Lyon

having been called as a witness by and on behalf of the plaintiff and having been first duly sworn, was examined and testified as follows:

Mr. Williamson: Your Honor, during the recess—I have one other very short point I want to bring out which Mr. Ed Penick could testify and Mr. Lyon can testify to it.

As a member of the board, Mr. Penick can testify with more authority. With the permission of the government, which I have, may I have, just where Mr. Penick stands, ask him a couple more questions?

The Court: Yes, but talk loud enough for the court reporter to hear you.

[394] Mr. Williamson: Mr. Penick, has Worthen Bank engaged in any other sale leaseback?

Mr. Penick: Yes, sir, we have.

Mr. Williamson: Could you describe what they are?

Mr. Penick: We have 13 branches and they are principally relative to our use of these branches. We have, I believe, four of those 13 branches under sale and leaseback arrangements with three different parties. One party has two of the branches under sale and leaseback.

Mr. Williamson: And these are independent investors?

Mr. Penick: Independent investors.

Mr. Williamson: No further questions.

The Court: Mr. Sayre, any questions on that?

Mr. Sayre: No, Your Honor.

DIRECT EXAMINATION

By Mr. Williamson:

Q. Mr. Lyon, please state your name and address A. I'm Frank Lyon. I live at Number 9 Sunset Drive.

Q. How old are you, Mr. Lyon? A. Sixty-four.

Q. What is your present position with Frank Lyon Company? A. Chairman of the Board.

Q. You have held that position since how long? A. Since 1967, '68, along in there.

[395] Q. Who is president of the company? A. C. W. Abrams.

Q. And he has been president since? A. January 1, '67 I believe it is.

Q. Would you please state where you received any higher education? A. I attended the University of Alabama for two years.

Q. Then what did you do? A. Went to work for Reynolds Tobacco Company for a few months and then worked for General Foods for five years.

Q. In what capacity? A. Salesman first and then district manager.

Q. Then what did you do? A. Then I went to work for Gunn Distributing Company as a salesman and then became sales manager of Gunn.

Q. Then what happened? How long did you work for them? A. Five years.

Q. Then what happened? A. In 1941 Marion and I, my wife, formed a partnership to distribute Zenith television sets.

Q. Was that the beginning of the distributorship that's now Frank Lyon Company? A. Yes.

Q. When did the company incorporate? A. [396] About 1946 or '7.

Q. And at that time the sole stockholders were you and Marion? A. Yes. I believe Ollis Matigan owned one share at that time perhaps.

Q. Since that time you and Marion have been the principal stockholders, as has been testified to? A. Yes. Yes.

Q. How long have you been a director of Worthen Bank? A. Since 1953.

Q. To shorten this testimony, Mr. Lyon, I won't go over much of the testimony that's been handled—that's been gone into with reference as to how the transaction devel-

oped. I'll just ask you first in connection with how Frank Lyon became involved in this situation.

You have heard Mr. Cotham testify. Is this substantially your recollection of how it came about? A. I think it was very accurate. I will subscribe to his testimony.

Q. Mr. Lyon, were you in connection with this new building—were you on the finance committee? A. I was not on the finance committee.

Q. Were you on a building committee? A. Yes, I was on the building committee.

Q. What function did you perform in that connection? [397] A. Well, I attended all of the meetings that I was available for and I think that was most of them. I recall making a trip to see Mr. Turner who was president of First National and I called Gus Ottenheimer and Worth James. I believe we were the only three. There may have been someone else. That's where I first heard of Mr. Morse.

Q. You were over there to inquire about their experience in bank building? A. Yes.

Q. You did participate then through the building committee in the selection of Mr. Morse? A. Yes.

Q. Did you participate in the selection of the architect or the contractor through your association on the board? A. Yes.

Q. On the building committee. A. Yes. On the building committee.

Q. But in this capacity you were acting for and in behalf of the Worthen Bank as a member of the board? A. Yes, sir.

Q. Turning to Frank Lyon Company's reasons for wanting to own Worthen Building, would you briefly in your own words testify as to what your motivations were? A. I would take the different priorities than Ralph [398] Cotham testified to yesterday. My main purpose and the purpose of the corporation and people involved was diversification.

At that time we had been in business some 26 or 27 years and had no diversification whatsoever. I think that perhaps some of my associates were somewhat critical that we hadn't gotten some diversification.

Q. Some of your company employees? A. Yes.

Q. Were they urging you to diversify? A. Yes.

Q. Would you go ahead. What other reasons were there for wanting to own Worthen Building? A. We felt that we could over the years build up a good equity in the building. Of course, we did consider the tax situation. It was not the overriding in my mind, and I don't think it was in anyone else's. We never let taxes override our judgment as to what is good for us and what isn't.

Q. Ralph Cotham testified as to certain investments that you have made or at least your companies which you own or control have made in real estate, and he mentioned the one IBM Building. And I would ask you first whether or not your experience with IBM has been limited to only one building or if you own—— A. No, sir, we have got two buildings for IBM. In [399] both instances it was handled very much like the Worthen Building was handled. We didn't select the architect or had nothing to do with the construction of it. We didn't select the contractor. In fact, I don't even know when they started or stopped. We had no one in our company who——

Q. You were strictly an investor and had nothing to do with the construction of the building? A. Correct, or the design of it.

Q. Pardon? A. Or the design of it.

Q. He also mentioned a National Cash Register Building, the Stover Building, a Gibson Products Building. Now that was in? A. Springfield, Missouri.

Q. Would you please state whether or not you owned the ground in that situation? A. We do not own the ground that the building is situated upon. We have a 15 year ground lease and perhaps four, ten year options.

Q. And you built that building on leased property? A. Yes, we did.

Q. Do you have any option to purchase the ground? A. No, sir, we do not.

Q. Now can you think of any other buildings or real estate ventures in which companies of Frank Lyon have gone into [400] as an investment? A. Yes, we built the Town and Country Shopping Center. Maybe the Safeway office building was mentioned. I believe that the National Cash Register Office Building was mentioned, We have built four buildings for ourselves: one in Shreveport, Louisiana, Springfield, Missouri, one in Fort Smith, Arkansas, and one in Little Rock, Arkansas.

Q. Those buildings that are actually occupied by Frank Lyon Company as tenant in connection with your business, these consist of both an office building and a warehouse complex? A. Correct.

Q. Does Frank Lyon Company own the building? A. No, sir.

Q. Again, these are real estate companies? A. Yes, sir.

Q. And lease them to Frank Lyon? A. Lease them to Frank Lyon Company.

Q. What about the Family Clinic Building? A. Yes, we built the Family Clinic Building close to Town and Country Shopping Center.

Q. What kind of building is it? A. A building for four or five doctors occupy. We also built the ESSO service station later on.

Q. In each of these real estate investments prior to [401] time the permanent loan—in the first place, did you finance each of these buildings? A. Yes.

Q. Prior to the time the permanent loan was paid off, did the companies who owned the building get any return or did the stockholders get anything out of those companies? A. I heard Ralph Cotham testify yesterday that there was a nominal return. I didn't know there was any.

I'm one of the stockholders. I certainly haven't ever gotten anything out of it.

Q. What then was your purpose in investing in these buildings? A. To build up equity in them. We think it is a good way to acquire equity and build up equity.

Q. Mr. Cotham also mentioned as one of the purposes for going into further expansion and further investment was to avoid the accumulation of earnings tax on unreasonable accumulation of earnings. Was that one of the considerations? A. That was prior to the Worthen Building. We had been warned we had been accumulating earnings.

Q. Warned by whom? A. By the IRS, of the Internal Revenue Service.

Q. And that you better do what? A. Make use of the money.

Q. Mr. Cotham also mentioned that the purchase of the [402] Worthen Building might strengthen your relationship with Worthen. What weight did you give to that particular reason. A. I heard Mr. Cotham testify to that. I don't take any stock in that now and I didn't then. I don't know how it would strengthen it.

Q. Turning now, Mr. Lyon, to the real meat of this question. In entering into this transaction, what was the intention of Frank Lyon Company as to whether or not this was a good faith bona fide investment by Frank Lyon Company in the building or whether it was the Frank Lyon Company served the role as a strawman or accommodation to Worthen in putting together this package. A. I had never heard that before until the last few weeks. It never entered my mind. I am really shocked that anyone would take that approach to it. We certainly wouldn't get on a $7 million note by ourselves as an accommodation to anyone. We've got to carry that on our balance sheet for 25 years and I might add that our suppliers, RCA and Whirlpool, are very zealous about our balance sheets: who we owe, how much we owe and how liquid we are.

Q. In your view and intent, did Frank Lyon Company borrow the $7 million interim loan from First National City Bank? A. I don't think there can be any argument or mistake about that at all. I think New York Life thinks that. First [403] National City Bank thought that. I don't believe that they would enter—I heard it called a sham deal here yesterday by someone. I just can't imagine. In the first place, Worthen Bank wouldn't do such a thing and I've known them a long while. I would like to think we wouldn't do such a thing.

Q. What was your intent with reference to the New York Life loan for permanent financing? By "your", I mean Frank Lyon Company. A. That the corporation owes it and it either has to go broke or pay it.

Q. At the time these negotiations were entered into, Mr. Lyon, was there any understanding either written or oral between Frank Lyon Company and Worthen Bank that Worthen Bank would exercise its option to purchase at any time? A. Absolutely none. At that time I didn't think they could exercise it. I still hold that opinion. Of course they have the final say in that, not me.

We went into it on the basis they couldn't then. I don't think they could now. I don't know as much about it as they do, however.

Q. You are a member of the board, are you not? A. Yes. Yes.

Q. You are aware of the capital inadequacy of Worthen Bank, are you not? A. Yes.

[404] Q. Is this a constant subject of discussion in the board meetings? A. Yes. Ed Penick testified to that rather in detail yesterday and today. As rapidly as they are growing under the leadership they have I don't think that's going to stop any time in the foreseeable future. Like most aggressive banks, they are going to be in a capital bind.

Q. As a member of the Worthen board, do you think it would be economically wise for Worthen to pay at the end of 25 years, even forgetting the much higher prices in earlier years—do you think Worthen would be economically wise to spend $2,146,000.00 round figures on that particular building in view of the fact that they have an option to renew the lease for 40 years at these very favorable lease terms?

Mr. Sayre: I would like to object to that question being put to this particular witness because he is the person whose interest could be affected should the option be exercised, and his testimony naturally—he would have a hard time separating himself from—wearing both hats in this instance.

It does call for strictly an opinion on something which Mr. Penick testified is not going to occur for a long period of time and will have to be decided at that time.

The Court: I have kept an open record here. I am going to receive it subject to the objection.

You may answer.

[405] The Witness: I think they can make better use of their capital, particularly at the low rent at that time. He can certainly tell more about it.

By Mr. Williamson:

Q. One other line of questioning, Mr. Lyon. Has Frank Lyon Company been approached since you bought Worthen Building? Have you been approached by other investors over the possibility of wanting to buy the Worthen Bank Building from Frank Lyon Company? A. Yes, I guess we have been approached at least a dozen times. The last one I recall vividly and I was impressed with was a company by the name of Cabot, Cabot and Forbs. I believe they are from Boston. They came to Little Rock and then wrote us a letter.

Mr. Williamson: Your Honor, I would like to introduce in testimony as Plaintiff's Exhibit No. 51, a letter from Cabot, Cabot and Forbs Equity Trust dated April 26, 1974 addressed to Mr. Frank Lyon, chairman of the board of Frank Lyon Company.

The Court: Any objection?

Mr. Sayre: Your Honor, may I finish reading it here?

The Court: Very well.

Mr. Sayre: May I ask for what purpose it is being offered?

[406] Mr. Williamson: I am offering it as proof that this identical package is an attractive investment opportunity for investors.

Mr. Sayre: I have no objection for that purpose, Your Honor, because we already have two other investors.

The Court: It will be received as Plaintiff's Exhibit No. 51.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 51 and was received in evidence.)

Mr. Williamson: Since the exhibit speaks for itself, Your Honor, I shan't ask anymore questions on this.

The Court: Very good.

By Mr. Williamson:

Q. One final question. Mr. Lyon, there's been introduced into evidence a letter which you wrote to Mr. Penick dated April 12, 1962 which has been introduced into evidence as Plaintiff's Exhibit No. 50.

Would you give the Court your recollection of that particular transaction?

The Court: That's April 12, '68, is it not?

The Witness: '68, yes, Your Honor.

Mr. Williamson: Did I say '62? Sorry.

The Witness: Yes, I recall the letter.

[407] By Mr. Williamson:

Q. Do you remember what concerns were being expressed? Who talked to you about it? A. Ed Penick talked with me about this and asked for such a letter and I thought it was completely in order at the time and still do.

Q. And his concern at that time as expressed to you was what? A. That someone might purchase the building that would be embarrassing to them; that they would like to have an owner that was not someone they would be embarrassed by.

Q. I believe, though, that this is directed toward the problem of Frank Lyon Company, not the building, ownership of Frank Lyon Company passing to some outside—— A. Yes.

Q. —person. A. Yes.

Q. Is this what that letter was directed for? A. Yes, it covered both of those subjects.

Q. Did Mr. Penick express concern not only as to current—that this possibility happening not only during the first 25 years but thereafter, at which time he would have no option to purchase? A. I think this letter covers that, if I understand correctly, and if I remember it right.

[408] Q. This was a concern of his, was it? A. Yes, and a very valid one, sir.

Mr. Williamson: No further questions.

The Court: Mr. Sayre, you may cross examine.

Cross Examination

By Mr. Sayre:

Q. Mr. Lyon, you were talking about the other buildings that you built in realty corporations where you are build-

ing up equity. Those buildings, do they have options to repurchase by the lessee? A. No, sir.

Q. So in other words, once the amount is paid off the realty company would be the owner? A. That's correct.

Q. Now in this venture with Worthen Bank, if you're building up equity in the building and at the end of any of the option periods, the value of that property has appreciated. Worthen Bank could exercise its option price and take the ownership of the building away from you and take the appreciation away from Frank Lyon and enjoy that themselves; is that correct? A. They certainly could.

Q. Now with regard to this transaction, there is no pretax cash flow for Frank Lyon Company; is that correct? A. That's correct.

[409] Q. And you said you had looked into diversification and equity interest and tax consequences and you had explored the tax consequences and the possible use of the tax deductions attendant to this transaction for the purpose of applying this other income of Frank Lyon Company? Had you made such computation? A. Yes, such computations were made. We hadn't looked into where we could use the money. We didn't know at that time.

Q. And the tax consequences—since there was no pretax cash flow, the post-tax cash flow created by the accelerated depreciation was an important factor in this deal. A. It was a factor.

Q. Now you said that with regard to Frank Lyon Company being a straw man or a conduit from both the First National City Bank loan and the New York Life loan, the agreement between you and Worthen Bank made it such that if Worthen Bank could not produce or finish the building as scheduled for any reason, they would agree to buy the building back from you plus a ten percent factor. So there was no risk to Frank Lyon Company with regard to that unless Worthen Bank went under; is that correct? A. I didn't recall that particular part of it. Ralph Cotham may have testified to that. I don't know.

[410] Q. With regard to permanent financing with regard to New York Life, everything was assigned to New York Life. By that I mean your rights under the lease, under the ground lease. A. Yes, sir. Yes, sir.

Q. Everything Worthen had in the garage. A. Yes, sir.

Q. Everything went to New York Life. A. Yes, sir, they will get everything they can. Q. Under this assignment or under the lease, there is nothing that will reduce the amount of rental that Worthen Bank is obligated to pay. If the building is damaged or if you owe Worthen Bank an amount of money, it can't be set off against it. In other words, there is an absolute obligation on the part of Worthen Bank to pay this amount of rent quarterly: is that correct? A. There is an absolute obligation on us to pay it also.

Q. Now you have assigned your rights under that lease to New York Life, and if you said you were alone on the note, if you do not make your payments, that the assignee, New York Life, has the right to collect the rentals directly from Worthen Bank; is that correct? A. I'm sure they do.

Q. And they are equal to the debt service that you [411] would owe; is that correct? A. I'm sure it is.

Q. Now with regard to Plaintiff's Exhibits 13 and 14, if we may have those, please.

Those are the specifications sheet of Worthen Bank as to what the package they would offer and the next one is your acceptance on behalf of Frank Lyon Company. Now on the first paragraph that's numbered, it says that equity of $500,000.00 would have to be put up for the interest rate to be paid at an interest rate of six percent. You have been in the courtroom during this time and it's been testified to that that six percent represents a return on the $500,000.00 if and when the option is exercised. Is that the way that that provision was understood by you or by Worthen Bank or at least by you at the time it was entered into? A. Ask me that question again. Re-state the question.

Q. The $500,000.00 provision at six percent interest, was it your understanding when you entered into this negotiation that that amount would represent or be represented by the option price, the amount to be realized by the option price? A. No, sir. At least that wasn't my understanding.

Q. What is the rate of six percent interest as stated on Plaintiff's Exhibit 13? What did that mean to you? A. Well, it just didn't have any meaning to me until [412] I got in here. I didn't remember about the six percent at all. I recall very distinctly we had to put up a half a million dollars in equity capital. I had forgotten about the six percent, if I ever knew it.

Q. Do you recall why when you responded to that provision that on the second page of Worthen's specifications they show the option price at 15 years, and when you replied you responded at 11 years. Do you recall why that—— A. No, sir, I do not. Their specifications is 15 years and we cut it to 11?

Q. It's re-stated as 11 on your acknowledgement. A. Their specifications were 15 and ours were 11?

Q. Referring to number six, which was the prepurchase at the 15th year and you responded and made a calculation of 11 years. Do you recall why the difference? A. No, sir, unless we were trying to make it more attractive to them so we would get the opportunity to own the building.

Q. The computations that you made or had made by Mr. Cotham show that the maximum tax benefit on the tax shelter would occur after 11 years; is that correct? A. I heard that yesterday.

Q. Now since this is a net lease and since Worthen Bank said they wanted this to be their building for their control of it, Frank Lyon Company assumes none of the risks of [413] operation of that building; is that correct? A. Correct.

Q. And with regard to the loan, Worthen Bank pledged land under the buildings and parking garage as additional security for the loan that was made ostensibly to you or to

Frank Lyon Company; is that correct? A. Correct. That is quite common. It also happened in Springfield.

Mr. Sayre: No further questions, Your Honor.

REDIRECT EXAMINATION

By Mr. Williamson:

Q. If Worthen Bank went broke, Mr. Lyon, would you be liable on your New York Life loan? A. Yes, sir, we would. If I understand correctly, we would.

Q. Were you in the courtroom this morning which it was brought out even if Worthen exercises its options to purchase at the end of the 11th or 15th year, that Frank Lyon Company is still liable on the note throughout the life of the loan? A. Yes, sir, I was here and heard that this morning.

Q. Did it come as some surprise to you? A. Yes, sir. It may not have to Ralph Cotham. I believe it came as a surprise to me and C. W. Abrams. I didn't [414] ask him yet. I didn't want to tell him right now.

Mr. Williamson: No further questions.

The Court: Let me ask you this: I want to ask who initiated the matter as between you and Worthen?

The Witness: I did, Your Honor.

The Court: Do I understand that rather late in the day you became aware of this situation?

The Witness: Yes, sir.

The Court: Latter part of October?

The Witness: Yes, sir.

The Court: At a time when the company was pretty far down the line in dealing with Goldman Sachs and the Stephens group and so forth?

The Witness: Correct. Yes, sir.

The Court: No one from Worthen came to you and said, "Why don't you put in a proposal?" Is that correct?

The Witness: No, sir, they sure didn't. In fact, I didn't feel like we were very welcome at that late date.

The Court: And you were not privy to discussions or associations with other people?

The Witness: No, sir, I have found out more about it in here. I'd like to know what it was.

The Court: You mean during the course of the trial you found out you probably left maybe $125,000.00 on the table?

[415] The Witness: Yes, sir. I got that feeling that we did.

The Court: All right. No other questions.

Mr. Williamson: No further questions.

Your Honor, the plaintiff rests.

Mr. Sayre: I would like to call very quickly Mr. Richardson to the stand, please, sir.

The Court: Come around, please, sir, raise your right hand and be sworn.

Thereupon,

Charles Richardson

having been called as a witness by and on behalf of defendant, and having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

By Mr. Sayre:

Q. Would you state your name and address, please, sir?
A. Charles Richardson, Number 9 Pyeatte Circle.

Q. What is your employment or profession? A. Internal Revenue Agent.

Q. Were you the agent that audited the Frank Lyon Company for the year in suit? A. That's right.

Q. You have been in the courtroom throughout this trial. May I ask if you are familiar with the transaction we [416] are speaking of? A. Yes, sir.

Q. At my request have you made certain computations reflecting certain tax benefits of Frank Lyon Company? A. Yes, sir.

Q. Specifically, I refer to Defendant's Exhibit No. 2 which is before you.

The Court: Is there an extra copy of that?

Mr. Sayre: There is one on the stipulation, Your Honor.

By Mr. Sayre:

Q. May I ask if that—what that exhibit shows as far as the pretax cash flow of the corporation to be? A. It shows a zero balance of cash flow in and out.

Q. Through the period of the first 11 years of the—— A. Lease.

Q. —the lease. And the—excuse me. After 11 years is the date the first option is exercisable; is that correct? A. Yes, sir.

Q. The figures on the bottom of the page show some computations at 25 percent and others at 48 percent. May I ask you to tell the Court what that figures of $649,756.00 represents? A. Well, that would be—this computation actually [417] is prior to the Revenue Act of 1969. It would change what the computation would be but this is made on the basis of the law prior to that. It would be the actual cash benefit that would flow to Lyon Company from this transaction if the options were exercised in 1980.

The Court: At the first opportunity.

The Witness: Yes, sir.

The Court: How can the Frank Lyon Company get its money back from Worthen, the borrower?

The Witness: By Worthen exercising the option.

The Court: In other words, there is no way legally he can get it back. It takes Worthen to make a decision for it to get any money back.

The Witness: To the best of my knowledge.

The Court: And it's the same thing in terms of making any income in terms of what you call interest. It takes a decision by Worthen to exercise the option.

The Witness: Right.

The Court: On the other hand, if they do not exercise those options, then what happens to your analysis in terms of the loan?

The Witness: You mean if at no time Worthen exercises the option? If Frank Lyon continues to be the owner of the building, per se? It wouldn't be right. It wouldn't be valid.

By Mr. Giroir:

Q. If Worthen never exercises the option and it's been accruing this six percent every year and at the end of 25 years [437] accrued two million plus dollars of income and paid taxes on it and then the option lapses, does Frank Lyon get a deduction for that $2 million? A. Which $2 million have you got in mind?

Q. The six percent you have been accumulating over 25 years. A. You mean——

Q. The income of $2 million that you have been accruing that all of a sudden they don't have the right to receive. What do they do with it? What do your regulations and guidelines tell them to do? A. They could file a claim. Wait a minute.

Q. Isn't it barred for every year past three years? And if they file a claim do they get it back with interest? A.

No. Wouldn't you mitigate Section 13.712? I'm not sure whether it would be effective or not.

Q. Doesn't it illustrate the ridiculousness of your accrual? A. No.

Q. Let me ask you one question. One of your factors was the down payment and the return of the down payment. Did you discover any evidence that indicated that Frank Lyon had a legal, written or unwritten, express or implied right to demand repayment of that 500, plus interest? A. No. Nothing written that I saw.

Q. Let me ask one other question now that has to do with [438] interim interest.

Did you observe the interim interest was, in fact, paid by the Frank Lyon Company? That is the interest during this period to First National City Bank, that $400,000.00. A. Yes, $456,000.00, right.

Q. Did you see the canceled checks? Did you see that they did pay it? A. I don't believe I looked at the canceled checks. I ordinarily wouldn't have.

Q. You heard testimony it was paid by the Frank Lyon Company? A. Right.

Q. Did you see anything that would have contradicted that testimony? A. I looked at the general ledger that satisfied me.

Q. That did satisfy you that Frank Lyon did pay it? A. Right.

Q. And yet you disallowed the deduction for that payment? A. Right.

Q. Did you also see the $7 million note that the Frank Lyon Company executed to First National City Bank? A. Did I see the note itself?

Q. Did you see evidence of the note? A. I saw evidence of the note. I'm not sure whether [439] I looked at the note itself or not, but I saw evidence to satisfy myself that——

Q. Under your instructions, if they, in fact, borrowed the money and, in fact, owed it and, in fact, paid interest

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS

May 16, 1975

Mr. J. Gaston Williamson
720 West Third Street
Little Rock, Arkansas 72201

Mr. Eugene G. Sayre
Department of Justice
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Mr. W. H. Dillahunty
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P.O. Box 1229
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Re: Frank Lyon Company v. United States of America
No. LR-73-C-247

Gentlemen:

Circumstances will not permit the Court to file an elaborate memorandum supplementing the findings and conclusions that it made in open court at the conclusion of the trial. Nor is an elaborate memorandum necessary in this case.

There are no true factual issues remaining, and the parties are in general agreement as to the applicable law. They do disagree with respect to the inferences to be properly drawn from the evidence and have different opinions as to the application of the legal principals involved.

The Government contends that although the "form" of the transaction was a sale and leaseback arrangement, the "substance" amounted to a nonrecourse loan for federal tax purposes. The plaintiff, on the contrary, asserts that the transaction, for federal tax purposes, was in "sub-

stance" exactly what it was in "form, that is, a sale-leaseback.

After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws.

The defendant concedes that Worthen turned to the sale-leaseback arrangement because of the net capital requirements of the Federal Reserve Board. See footnote, page 1, Defendants Supplemental Memorandum of Fact and Law, filed December 20, 1974. It is likewise clear from the evidence that Worthen was going with such an arrangement, one way or the other, before the plaintiff entered the picture.[1]

The theory of the defendant that the plaintiff "loaned" Worthen $500,000 is completely untenable, both in fact and law, as indicated by the Court at the conclusion of the trial. As there stated, it is most unlikely that Worthen will exercise the option at the end of eleven years, or, indeed,

[1] The Court senses that a controversy might not have arisen at all had Worthen concluded the same, identical, transaction with parties other than the plaintiff. The close relationship between the plaintiff and Worthen appears to have made a great impression upon Mr. Charles Richardson, the agent who wrote the report which started this case on its way to this Court.

arising out of lessee's use of the premises and to pay rent during the initial term in an amount sufficient to amortize the mortgage on the building are all terms which are quite common in long-term real estate leases. Such assumption by Worthen of the risks of operation normally borne by an owner did not make Worthen the owner of the building for tax purposes.

9. All of the other terms of the agreements among the parties and the surrounding circumstances which defendant contends are collectively sufficient to make Worthen the owner of the building for tax purposes are common in and consistent with a bona fide sale-leaseback with option to purchase, and do not, individually or collectively, make Worthen the owner of the building for tax purposes.

APPROVED AS TO FORM:

/s/ J. GASTON WILLIAMSON
J. Gaston Williamson
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Little Rock, Arkansas 72201
Attorney for Plaintiff
W. H. DILLAHUNTY
United States Attorney

By /s/ EUGENE G. SAYRE
Eugene G. Sayre
Attorney for Defendant

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Judgment

(Filed June 11, 1975)

Findings of fact and conclusions of law having been entered in the above-styled case, judgment in conformity thereto is hereby entered in favor of plaintiff in the following amounts with interest thereon from the dates indicated:

$32,624.32 with interest thereon from March 15, 1969;
$231,871.26 with interest thereon from March 15, 1970;
$43,790.84 with interest thereon from April 19, 1973.

DATED this 11 day of June, 1975.

/s/ GARNETT THOMAS EISELE
District Judge

By Mr. Sayre:

Q. Now——

The Court: In other words, you are saying the known tax benefit in effect would be zero and the tax based—and I mean the cash flow resulting from the depreciation.

The Witness: It's really a two part. The first part, the $3,458,174.85 would be the capital gain which Frank Lyon would realize—Frank Lyon Company would realize in 1980. That would be taxed at 25 percent.

The Court: Upon the exercise of that option.

The Witness: So they would have that much tax liability at that time. The tax they would save would be the savings from the rental loss.

By Mr. Sayre:

Q. The rental loss is the $3,154,000.00? A. Eight hundred nineteen and eleven cents. It's at 48 percent.

Q. So the tax savings in tax dollars through that 11 [418] years would be the six hundred forty-nine thousand? A. That's right.

Q. That would be in tax dollars that had been saved up to that period? A. That's right.

Q. That doesn't include the actual cash realized upon the sale? A. No. No. That is tax dollars saved.

Q. Exhibit No. 3, would you identify that to the Court, please? A. Exhibit No. 3 is a computation of the rental operation for this 11 year period that we are referring to through November 30, 1980 and it would show the net rental loss that we referred to on the prior exhibit.

Q. And the net rental loss over that period of time would be how much—and the net loss to Frank Lyon attributable to these rentals—that being the interest and depreciation—would be how much? A. Three million one hundred fifty-four thousand eight hundred nineteen and forty-four cents.

Q. No. 4 is what, please? A. No. 4 is a computation of what the gain would be to Frank Lyon Company if the option were exercised in 1980. That's the sale price over the adjusted basis to Frank Lyon Company at that date. [419] Q. That being taken on the double declining balance method? A. Right.

Q. That is the figure that was plugged in on Exhibit No. 2? A. Yes. Yeah.

Q. Now Exhibit No. 5. Will you identify that for the Court, please? A. Actually, Exhibit 5, the applicable part here really is economic gain, which is shown in the bottom half of that exhibit, and the economic gain would be the gain on the sale of the building back to Worthen less the rental loss, disregarding taxes.

Q. When you say "the economic gain", we are referring to the amount of actual cash realized by Frank Lyon over and above the original $500,000.00 investment? A. Yeah. Yes, sir.

Q. And does this correspond then to what Mr. Cotham testified to as the approximate $800,000.00 figure? A. Yes. I don't have them in front of me, but the adjustment as set up in my RAR reflects it that way. Revenue Agent's Report.

Q. Would you reflect it as an $800,000.00 gain with a $500,000.00 return of equity and a $303,355.74 return of profit? [420] A. Right.

Q. Now if you take the actual cash amount realized, which has been testified to be the six percent figure, the three hundred thousand, would that be added to the $649,769.46 in tax dollar savings? A. That's right.

Q. So there would be an economic benefit under the pre-1969 law of approximately $950,000.00? A. Yes, sir.

Q. If the option is exercised after the end of 11 years; is that correct? A. That's right. That's right.

Q. Defendant's Exhibit No. 6. Can you identify that for the Court, please? A. It's a similar computation with the option being exercised after 11 years taking into account

the changes in the tax law as it would affect this type transaction by the Revenue Act of 1969.

Q. What is the major change that affects this, please? A. It would——

Q. Excuse me. The basic change in the revenue law, the Act of '69 would have affected this transaction? A. Part of the gain would be recognized on a sale in 1980. Part of the gain would be recognized as ordinary income rather than as a capital gain. They changed the rates.

[421] The Court: I need to see No. 6.

By Mr. Sayre:

Q. You said part of the gain would be realized as ordinary income rather than capital gain? A. That's right.

Q. What part is that? A. What's the dollar amount of that? Is that what you mean?

Q. What I'm saying—— A. How do you arrive at that?

Q. —what is it attributable to? A. It is the excess of the accelerated depreciation over straight line depreciation over the 11 year period.

Q. Has that been calculated on this exhibit? A. Yes.

Q. Now the direct benefit is the cash benefit received or cash money received at the exercise of the option, the three hundred three thousand three fifty-five seventy four. That would not have changed? A. That still would be the same.

Q. What is the tax savings or tax dollar benefit? How was that computed? A. Well, it would be the rent loss—the savings would be the tax on the rent loss as it was computed originally on the original computation. That amount is 48 percent of [422] of $3,154,819.00 or $1,514,313.17.

Then in 1980 the taxpayer would have to recognize the part of the gain which is considered Section 1250 gain as ordinary income.

Q. Excuse me. That is the accelerated depreciation has to be recaptured? A. Yes. That is the excess. Right. And

that is $914,668.15. And the tax on that which the taxpayer would have to pay would be $439,040.71. Then the balance of the gain would be capital gain, and the rate at present on a capital gain would be 30 percent of it.

Q. What would be the balance? Is that shown on the last line? A. Yes. $2,543,506.70.

Q. And what would the tax on that be? A. $763,052.01. So that would be a tax that the taxpayer would incur also in 1980 if he exercised the option.

So the net gain in taxes would be the difference between the tax savings on the rental loss less the 1250 tax and the 1231 tax, so it would be a net tax savings of $312,220.45.

This is over the period of the 11 years of the transaction; is that correct? A. Right.

Q. And then what would the total of that tax savings [423] and the direct cash received on the sale and the gain be? A. The total savings would be $615,576.19.

Q. That is as opposed to the total of $649,303.00 or some $950,000.00 under the pre-'69 law? A. Yes, sir.

The Court: Which law will apply?

Mr. Sayre: The post '69 law, Your Honor. We prepare these to show both the computation at the time the transaction was entered into and as of present date.

The Court: Of course, the law could change again.

Mr. Sayre: The law could change again.

I have no further questions, Your Honor.

The Court: Any questions of this witness?

Mr. Giroir: Yes, Your Honor.

The Court: In other words, just roughly, the benefit to the taxpayer under the prior law, about two-thirds of his benefits were as a result of the tax laws and about one-third, more or less, the economic benefit?

The Witness: Yes, sir.

The Court: And under the present law about half and half?

The Witness: Yes, sir.

CROSS EXAMINATION

By Mr. Giroir:

Q. Mr. Richardson, how long have you been with the [424] Internal Revenue Service? A. 1956.

Q. In what capacity? A. Internal Revenue Agent.

Q. You have been an agent during that entire time? A. Afraid I have.

Q. What is your educational background? A. I have a B.S. degree from the University of Arkansas in accounting.

Q. Any other degrees? A. No.

Q. Have you had any formal training in taxes? A. Within the Internal Revenue Service we have, yes.

Q. What type of program do you have? A. A basic revenue agent school and I have attended that.

Q. When did you attend that? A. 1956.

Q. Have you attended any school since that time? A. Advanced schools since then and then we have more or less workshop or annual institutes that we attend a week or a few days sometimes.

Q. A week or a few days? A. It will be a week or two or three days sometimes.

Q. How often does that occur? [425] A. Annually.

Q. Are those general type seminars? A. Primarily just tax changes.

Q. Have any of them been on real estate transactions? A. Not specifically.

Q. Have you ever done any specific study on real estate transactions? A. Just when as a revenue agent I had a problem that dealt with real estate.

Q. I assume that problem would only come up if you were examining someone who had a real estate investment; is that correct? A. Or sold real estate.

Q. Who had an investment or either operated it or sold it? A. Right.

Q. But you are—or are you familiar with the laws and the regulations and the rulings dealing with depreciation? A. To some extent at least I am.

Q. You seem to be qualifying. Are you or are you not familiar with the laws. A. Specifically what do you have reference to?

Q. The ones that are in issue here in this case. A. I think I am. I certainly hope so.

Q. And also with respect to the capital gains on sale [426] of a capital asset, are you familiar with those rules and regulations? A. I think so, yes, sir.

Q. And as to the deductibility of interest—— A. Yes.

Q. —are you familiar with those rules and regulations? A. Yes.

Q. Have you ever examined any other corporation that is of similar size to the Frank Lyon Company? A. Yes.

Q. How many? A. How many?

Q. Yes. A. Gosh, I don't know; four or five a year maybe for the last seven or eight years.

Q. So four or five times a year for the last seven or eight years you have encountered tax returns involving corporations of at least the same size in terms of assets and revenues as Frank Lyon Company? A. Yes.

Q. And with problems as complex as those you found in Frank Lyon's tax return? A. I would think so, yes, sir.

Q. How many corporations do you examine regularly who have or which have real estate investments? [427] A. Ordinarily, not of this type. I have had a similar problem but not quite like this.

Q. How many have you examined that have real estate investments? Can you tell me how many corporations' returns? A. It would just be a guess.

Q. Could you guess? A. Four, six.

Q. Four or six over the last 25 years? A. No.

Q. Four or six a year? A. No. Four or six over the last seven or eight years. We are talking about this size corporation.

Q. I am thinking now any corporations that have similar type real estate investments. A. I don't know of many corporations in Arkansas that have similar type real estate investments. Personally, don't.

Q. But in any event, you have not examined any that have similar type real estate investments? A. Exactly like this, no.

Q. Have you examined many that own real estate as an investment? A. Yes.

Q. How many? A. I'd say four or five.

Q. Over your 25 years? [428] No, over the last seven or eight years.

Q. Four or five corporations that have real estate investments?

The Court: Let me ask so I can understand why you are pursuing this. Do you disagree with the analyses which have been made by this witness and reflected in the exhibits introduced or referred to?

Mr. Giroir: Your Honor, this agent prepared an RAR, which proposed a deficiency in the tax paid by the Frank Lyon Company. One of his findings was, and I quote, "It has been determined based upon the facts and circumstances that you, Frank Lyon Company, are not the owner for tax purposes or any portion of the Worthen Building."

The Court: Well, that really is beyond the scope of cross examination, but you are about to take him into new matters. I didn't know whether you are going into his qualifications on the ground you were disagreeing with these matters or, as I now see, you want to turn to a new matter.

All right.

Mr. Giroir: While I have mentioned it, let me introduce into evidence—I'm sorry I don't have copies—but one page from the RAR that deals with this problem. It's page six of the RAR for the years 1969 and 1970.

I'd like to ask the Court to be able to reproduce it and furnish it formally. I believe Mr. Sayre has seen it.

[429] The Court: That was prepared by the witness?

The Witness: Yes.

The Court: Hand it to him and ask him if it is so.

The Witness: That's right.

The Court: All right. It will be Plaintiff's Exhibit 52. Any objection?

Mr. Sayre: No, Your Honor.

The Court: It is received without objection.

(The document referred to was marked for identification as Plaintiff's Exhibit No. 52 and was received in evidence.)

Mr. Giroir: I won't need it for reference, Your Honor.

The Court: Then I will look at it.

All right.

By Mr. Giroir:

Q. Now as to real estate investments, generally, are you familiar with the laws dealing with accelerated depreciation versus straight line depreciation, which were in effect in 1967, '68? A. Right.

Q. Would you explain exactly what accelerated depreciation is? A. Well, it's double declining and some of the year's [430] digits are—that's primarily accelerated depreciation which allows the taxpayer to claim more, an amount greater than straight line in the earlier years of the life of the assets.

Q. And what happens during the subsequent years? A. It tapers off and gets lesser as the asset ages.

Q. Do you know the theory behind or the reason for the allowance of accelerated depreciation? A. Well, I think I do. I'm not sure that I know.

Q. Would you state your best understanding of it? A. My understanding is that it allows the taxpayer to recover cost in the earlier life of the asset as he's expending paying for the asset in the earlier part and also for immediate obsolescence of assets and expenses of that nature.

Q. When you say "to encourage investment", are you saying that the code—— A. Well, I don't—did I say encourage investment?

Q. I think you did. A. I think that is a factor but I didn't know that I said that.

Q. Is this an approved form? A. Oh, yes. Yes.

Q. And is there anything illegal or immoral or improper about taxpayer utilizing accelerated depreciation? A. No, sir.

[431] Q. Does it become illegal or immoral or improper if you buy an asset intending to use accelerated methods? A. No.

Q. As to capital gains, what rate is applicable to capital gains for corporations? What rate of tax? A. When?

Q. On a long-term capital gain. A. When? What year are we talking about? It changes with the Revenue Act of '69. It went from 25 to 28, 28.7.

Q. Well, state for both periods then. A. Well, for long-term?

Q. Yes. A. Well, the Revenue Act of 1969 changed it from—it had been 25 percent for a corporation for—since Revenue Act of 1954, Internal Revenue Code of 1954. Then '69 Revenue Act changed it starting, I believe in '70 for 28.7 or——

Q. Roughly 25 to 28 percent? A. Then it went to 30 percent.

Q. Twenty-five to thirty is the effective rate on capital gains for corporations? A. Right.

Q. How is depreciation classified as an expense? Is that ordinary expense or a capital expense? A. Ordinary.

Q. And that is reduces tax to a corporation such as [432] Frank Lyon—— A. Correct.

Q. ——which is at the maximum bracket, at what rate? A. Whatever their tax bracket is.

Q. What is the maximum bracket? A. Forty-eight percent.

Q. So to Frank Lyon it reduces their taxes by what percent? A. Forty-eight percent.

Q. Now 30 to 48 percent is what percent difference? Eighteen? A. Yeah, percent. Okay.

Q. If an asset is depreciated and you receive an ordinary deduction and then it's sold at a price in excess of its cost basis, depreciated cost, then you pay tax on the gain at what rate? A. Capital gain rate.

Q. And we'll say for Frank Lyon what percent? A. Between 25 and 30. You know, it just depends on which year. In 1980 you would say it would be based on the law right now—it would be 30 percent.

Q. So he could have got a deduction at 48 percent and paid tax at 30 percent and received an 18 percent benefit? A. Right.

Q. Is that legal? [433] A. Yes, sir.

Q. Is anything wrong with doing that? A. No.

Q. It is sanctioned by the law and the code? A. Right.

Q. Does it become wrong if you buy a capital asset intending to take advantage of this difference between the rates? A. Does it——

Q. Does it become illegal if I buy a piece of property intending to depreciate it at 48 percent and sell it and pay tax at 30 percent and pocket the 18 percent difference?

Is there anything illegal about that? A. Not to my knowledge.

Q. Is it illegal if I intend to do it when I buy this asset?

The Court: We don't need to ask this witness what is legal and illegal. What I would like to find out is an answer to this question: In your explanation here you say: "It has been determined based on the facts and circumstances that you are not the owner for tax purposes of any portion of the Worthen Building."

Would you tell the Court what the facts and circumstances were upon which you predicated that statement?

The Witness: Well, it was my determination at the [434] time that, as a revenue agent, in my opinion Frank Lyon Company didn't own the building, as such. If they didn't own the building——

The Court: You based that upon facts and circumstances, you say. What were the facts and circumstances that made you conclude they did not own the building? They had the title and it was on record down there in the courthouse.

The Witness: They had the bare legal title. The Worthen Bank assumed all the risk of ownership, they paid the taxes, they——

The Court: On the land, you mean.

The Witness: They paid taxes, insurance, and all other expenses.

Could I refer to my report?

The Court: Certainly.

The Witness: Another factor would be that part of the assets owned by Worthen were used as security for the loan, indicating to my way of thinking that it was their asset.

And the option to repurchase would be another indicating maybe—you know, in favor of saying, to my way of thinking, that Worthen owned the building.

Conduit of the pass on the rental payment. The ground lease being a nominal amount. The risk of ownership. I previously mentioned that. Again, the down payment and [435] the return, which is practically equivalent to the interest factor which has been previously discussed. Those were primarily my reasons.

The Court: Let's see if we can deal with that and maybe find out the more critical ones. Is there anything unusual in a lease arrangement between the landlord and the tenant for the obligation—for the lease agreement to provide that the tenant will pay the taxes and the insurance?

The Witness: Well, it's just one of the group of factors, the way I look at it. It, in itself—if none of the other factors had been present, I would say no.

The Court: Is there anything unusual with the tenant in the lease having to repair and maintain the building?

The Witness: Not in itself.

The Court: Now have you had experience with many of these sale and leaseback arrangements?

The Witness: No. I'm finding many more people that are expert than I am in this courtroom.

The Court: Do you have instructions from the department which tell you what to look for and what makes a transaction, in effect, a ruse: not what the papers say it is, but, in fact, something else?

The Witness: Basically, I try to research the issue since it is facts and circumstances what really make the [436] decision. Substance versus form. In its form I have no question in my mind.

The Court: You have treated this as a loan of $500,000.00?

The Witness: Correct.

on it, weren't they entitled to a deduction? A. Ordinarily I'd say yes, but——

Q. What distinguishes this situation? A. As I told the Judge, that the evidence to me indicated that Worthen owned the building, that Frank Lyon Company was not really the beneficial owner of the building.

Q. Even in Frank Lyon Company was lending $7,640,000.00 to Worthen for Worthen to construct its own building and if Frank Lyon Company had to borrow seven million of it and pay interest on that borrowing, weren't they entitled to a deduction? A. Well, under the way I see it is that they did not own the building and as long as they didn't own the building they wouldn't be entitled to the deduction.

Q. Even if they in the wildest stretch of your imagination did what you said they did and bought it on a pure financing arrangement and leased it on a financing arrangement in your terms to Worthen, if they had to borrow the money to buy the asset to lease it, weren't they entitled to an interest deduction on what they borrowed? A. If they have no assets——

[440] Q. But they've got a $7 million obligation on which they had to pay interest. Now did you consider in your research recent revenue ruling 72543, which involved a leasing situation, a pure leasing situation where the leasing company had to borrow money to buy the assets to lease, which the government treated as a financing arrangement? In that instance the government ruled that the leasing company, even acknowledging some viability to your organization, that the leasing company was entitled to an interest deduction and to a deduction for attorneys expenses involved in acquiring the assets they are leasing. I assume you are bound by the revenue rulings? A. Yes.

Q. Did you consider that? A. I sure didn't. I don't remember if at the time I did or not. I can't tell you. I could look at my research and tell you if you would like for me to do that.

Q. You have assumed that the option will be exercised, have you not? That the option Worthen Bank has to buy the building will be exercised? A. I made a computation to that effect.

Q. You haven't assumed it will? A. Made a computation to that.

Q. In your revenue agent's report, did you assume that the option would be exercised? [441] A. No.

Q. Did not assume it would be exercised—— A. I don't——

Q. —at the 11th year? A. I'm not following your question.

Q. You have testified to the Judge that the only way that you know of that Frank Lyon Company is going to be "repaid its down payment plus interest" is through the exercise of the option.

Now if that's the only way that Frank Lyon Company is going to be repaid, I have got to think that you assumed that the option was going to be exercised.

I will repeat: Did you assume the option was going to be exercised? A. I don't think I'm following you. I don't see how I can say that I assumed that. What I meant to say was at the time I wrote my report I determined that Frank Lyon was not the owner of the building.

Q. Would your report have been the same had there been no option? A. Well, I don't know how to answer that right now since it was there. I can't say for sure.

Q. If you had known all the facts that you know now and the option was there but you were told by Frank Lyon and confirmed by Ed Penick that was legally impossible for the [442] option to have been exercised, would your report have been the same? A. I'd have to study it some more.

Q. In other words, the likelihood of the exercise of the option at any date was not of material importance to you in writing your report? A. It was a factor. I sure was.

Q. But not a major factor? A. Well, it was—I couldn't say it was the major factor but I'd say it was a factor. I couldn't tell you how much weight right now.

Q. Well, let me ask you one final question: If, in fact, Worthen Bank was a lessee of the building Frank Lyon was the owner of the building, would all of the related adjustments which you made in your RAR be incorrect? All of them related to the building? A. If now——

Q. If you assume there was substance to Frank Lyon's ownership of the building? A. All right.

Q. —and if you assume it was truly leased to Worthen Bank and that the ownership of the building was in Frank Lyon and all the economic risks and gain were in Frank Lyon, that Lyon borrowed money from First National City, Lyon borrowed money from New York Life, owns the building subject to a lease, [443] then if that was your determination, would all of your adjustments as they relate to the building be wrong? A. Yes.

The Court: Certainly.

By Mr. Giroir:

Q. One final question. How can you impute interest if you don't assume the exercise of the option? A. Well, I don't think I put it that way in my report. Could I look at that page just a second there?

Q. Yes. A. I think in my—well, following this through, it would be the equivalent of the interest. This $500,000.00 that Lyon Company had loaned would be——

Q. You would have predicated it on a theory of a loan: a loan from Lyon Company to Worthen Bank? A. Rather than as——

Q. Let's stay to the $500,000.00. You would have assumed that Frank Lyon loaned Worthen $500,000.00; is that correct? Is that the basis on which you imputed interest? A. That would be the basis, right.

Q. Now when there is a loan there must be a repayment or else it is not a loan; it's a gift. Is that correct? A. That's right.

Q. When, under your theory, was the payment to occur? A. Well, under this theory, under the government's theory, since Worthen owned it all, the contract was——

Q. I'm sorry. I missed that answer. [444] A. It would be—under the government's theory, Worthen actually owned the building and all Frank Lyon would get out of it would be a return on his investment of $500,000.00—return on his loan of $500,000.00.

Mr. Sayre: Excuse me, Your Honor. We are belaboring this. We have agreed that the interest factor would come in only when the option was exercised. We will stipulate to that.

Mr. Giroir: What's bothering me is that the agent who wrote the report assumed a loan and a repayment and he's now unable to explain how it is going to be repaid. That's my question.

Mr. Sayre: We will be glad to stipulate we assumed the exercise of the option to create the interest factor of six percent.

Mr. Giroir: Your witness who wrote this report is not stating that was in his mind, and that's what I'm trying to ask.

Mr. Sayre: As far as that goes, the acts of the agent do not bind the commissioner and as far as the government is concerned in the matter we would agree that the assumption was made that the option would be exercised to come up with the interest factor.

To belabor the point, whatever Mr. Richardson's attitude is on it at the present time is not material.

[445] Mr. Giroir: Mr. Richardson's analysis of the entire transaction is what precipitated this lengthy and ex-

pensive trial. I think we are entitled to have his analyisis of how he got from there to here.

The Court: I think we are almost gettting down to the point of just arguing. He stated how he arrived at the idea that it was a loan and how he understood it would be—the interest so-called—would be paid.

The Witness: I think I misunderstood you, too. It would be on that same basis as I have written there, based on 11 year period, payable—then.

By Mr. Giroir:

Q. What is the 11 year period? A. The time period when the option—when Worthen's option would come up to repurchase.

Q. So you assumed that would be an exercise at the end of 11 years? A. Yes.

Q. Why did you pick 11 rather than 15 or 20 or 25? A. That was the first option period.

Q. Why did you make the assumption at all? A. Well, that was the first option period and that was the logical period for it to be exercised.

Q. Why did you make the assumption that it would be [446] exercised. On what basis did you make it? A. On the basis that it was a loan.

Q. Can you allow interest as an expense or require the recognition of interest as a gain if the likelihood of realizing that interest is uncertain? A. If the likelihood is uncertain?

Q. If there is no certainty that it will be paid. A. If there is no certainty that it will repay, I wouldn't think so, no.

REDIRECT EXAMINATION

By Mr. Sayre:

Q. Mr. Richardson, with regard to the issue of whether or not the party to this transaction who would bear the

economic loss or who would bear the economic burden of the wear and tear on the building, it was your testimony that—or your determination it was Worthen Bank rather than the Frank Lyon Company; is that correct? A. Yes, sir.

Q. In the substance of the transaction between these two, instead of the form; is that correct? A. Yes, sir.

Q. You disregard the form of the transaction? A. That's right, disregard the form.

Q. Was it your testimony that the some eight or ten factors that you considered at the time, that no one of those [447] factors was the key determining factor, but all of them taken together? A. All of them taken together, yes, sir.

Mr. Sayre: No further questions.

The Court: You may stand down.

(Witness excused.)

The Court: All right, Mr. Sayre.

Mr. Sayre: Your Honor, the government will close except for cross examination of the taxpayer's witness.

The Court: Anything else?

Mr. Williamson: Nothing further from the plaintiff.

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[3] PROCEEDINGS

[Filed June 3, 1975]

• • •

The Court: What is your preference, gentlemen? This case turned out to be very much as I anticipated when we walked into the courtroom yesterday morning. Having heard the parties at pretrial conference and having read

the pretrial memoranda, it was obvious there really were very few, if any, issues of fact, although there were questions as to the inferences that could be drawn.

I think the Court has benefited very much from the testimony. I don't mean the trial wasn't helpful or necessary; I simply mean as it turns out there were, as anticipated by everyone, very few factual issues. The trial has been used as a vehicle to educate the Court and for the parties to argue their position, for which I thank you.

Now what do you want to do? Do you want me to take the whole matter under submission, or do you want me simply to rule at the earliest possible time with or without additional argument?

Mr. Williamson: Your Honor, plaintiff, I think, has adequately stated its position through the pretrial brief and the evidence introduced here. We see no further reason for delay in the decision, and if the Court feels inclined to rule from the bench, it's satisfactory with us.

Mr. Sayre: Your Honor, as requested in the pretrial [4] memorandum, I would like the opportunity, once the facts and inferences the Court mentioned had been established at the trial, to highlight those in written argument by way of a post-trial brief.

I believe that the factors requested by the Court with regard to—as highlighted in the cases that I cited to the Court the other morning could more appropriately have been made in a written argument than they were in the oral statement. I would request the opportunity to argue those to the Court in a post-trial brief. I believe that while the case is fresh on my mind that within a period of 20 days I can file a memorandum. The reason being that the holiday delay here at the present time will necessitate a short delay in getting back to my typist in the office.

Mr. Williamson: Your Honor, I might point out that the Government itself admitted in the pretrial conference he

thought the facts were—there would be no substantial dispute as to the facts. The Court solicited from the Government a further pretrial brief to fully state his position and the cases on which he relied and the facts on which he relied. The Government didn't elect to do so, and I see no reason in further briefing the thing again.

The Court: Well, I indicated when I started that I do not consider myself an expert in the tax field, and I am going to give the Government an opportunity to submit a brief [5] based upon now a fully developed record, but with some limitation in this respect: I am going to make one or two findings and conclusions simply to avoid the necessity of anyone wasting time on certain matters.

I think the heart of the matter here is whether, as the Government states it, Frank Lyon is, for tax purposes, the owner of the building. I say that because there isn't any question in my mind that under Arkansas law and all the law we are used to applying that Frank Lyon is the owner of the building.

So the only real question is: Is there a different result in the application of the tax laws or the manner in which you apply the tax laws. This gets back to the substance versus form argument, and I am going to give the parties an opportunity to get into that.

I do want to say this: One of the factual issues, so to speak, that has been tendered has been resolved beyond any question from what I have heard here. There is no basis from which anyone could find on this record that Worthen will exercise the option at the end of the 11 years or at any subsequent option period. The evidence makes it quite clear that it is highly improbably that it will exercise that option at the eleventh year and very unlikely it will exercise it thereafter, but it has the legal right to do so.

I am simply making this determination that there is [6] no factual basis for the Commissioner to determine or for this Court to determine or for any tryer of fact to determine, upon the basis of what we have heard here, that Worthen will do it.

I think all we have is the admission and the conceded position that they have the legal right to. The evidence would indicate that it is highly unlikely that they will because it will probably not be in their best interest to do so. The farther down the line you look the less concrete can be your prediction, but that, I think, is quite clear.

Now there is another thing from a legal point of view in terms of the substance, if you will, that I don't think the parties need to worry about: I am going to look very hard at the question of who owns that building in the terms of the legal realities and the arguments that you present to me.

If it turns out you are able to convince me—and I think I am looking at you because I really feel that at this juncture the Government needs to convince me that Frank Lyon Company is not the owner, for tax purposes, of this building. If it turns out that it is not, though, and you can show me the indices by which the courts have decided this should be considered to be Worthen's building, there is one other conclusion and factual determination that is quite obvious—that is, that if the relationship is not what it says it is, it is also not a loan. There is no loan here. There is no obligation or agreement to repay the $500,000.00, and there is [7] no agreement enforceable by the lender to obtain repayment of his loan or to obtain the so-called "interest". So you will have to tell me what it is if it's not a loan and if, in fact it is that Worthen does own the building.

Those two determinations are all that I am going to make. They are facts and they are tied together very closely

because the whole concept or idea of the loan really is tied to the Government's theory that they will exercise the option and unless the mere right to exercise it is enough to create the irrebuttable presumption that they will, there is certain no evidence to indicate that the option will be exercised.

With those limited comments, I want to hear and see particularly I would like to see the Government analyze the sale-lease back transaction and show me the ones where the arrangement is satisfactory for tax purposes and then how this deviates and those cases which indicate that these other circumstances which we have here would make it not be the true owner.

If it turns out the agent did not make much of or anything of the fact Mr. Lyon was on the board of Worthen and was also on the board of the other company—the close relationship apparently did not in any way affect it, nor do I know of any law which makes a transaction between those closely connected businesswise unacceptable.

He emphasized the fact Worthen pledged other asset [8] to assist in obtaining the interim and permanent financing. He emphasized the option to repurchase. He emphasized the fact that the agreement rentals were exactly equal to the loan payment on the permanent financing and that, therefore, the plaintiff was, as he put it, a conduit. So I would like to know this: Does it become less objectionable if the amounts are below or above the exact amount that is required to discharge that?

The ground lease thing impressed the agent. I know that what the agent determines is not binding upon the Government, but these are the factors that resulted in this case being here. Frankly, having listened to all the testimony, I would need you to point out how that is important because it occurs to the Court, as testified by every witness that testified, that if you put it at a rea-

sonable sum instead of $50.00 they simply raise the rent by that much.

So there is nothing that the Court can see, on the basis of the testimony in the record, that would change the transaction if you have it a reasonable rent, as you put it, for the ground instead of a nominal rent because it could be passed on and would just simply be a circuitous transaction. If it were $100,000.00 instead of $50.00, it would come right back by way of increased rent.

He was impressed by the fact the tenant had all the instances, in effect, of ownership in the sense of [9] control of the building, responsibility for the loss or damage, maintenance, upkeep, and so forth.

He, I think, was impressed by the fact if you took the amount of the down payment, $500,000.00, and you assumed Worthen would exercise the option and read the record that indicated they were looking at a six percent return, that, in effect, would return six percent at the end of 11 years if Worthen exercised that option.

That, of course, is clear to the Court from the evidence, is the least that the Lyon Company could make out of this transaction—that is, the tax benefits and the economic benefits if Worthen exercised the option at the end of 11 years.

In any other posture it gets better in terms of the benefits to Frank Lyon Company. Even on the so-called least picture they make substantial returns as evidenced by the agent's figures, based upon either the pre-1969 or the post-1969 Code: approximately $600,000.00 plus in tax benefits under the pre and about $300,000.00 under the post, and in either case approximately the same amount, three hundred something thousand dollars, in clear economic benefit upon his investment of $500,000.00.

I will give you until—this is the 27th. I will ask the parties to file simultaneous briefs by the 20th of December,

and then you will be given until the 27th to respond [10] to your adversary's memorandum.

Mr. Williamson: That's December 27th, Your Honor?

The Court: That is bad, isn't it?

Mr. Sayre: Your Honor, 'm going to be out of the country from the 20th until about the 30th of the month. I plan to take a vacation to Mexico. If we could have, say, until the 7th of January, which would be after the holiday period, that would give us a week.

The Court: All right. You will have until the 20th to file your original memoranda and until, say, the 7th of January to reply.

Mr. Williamson: Thank you, Your Honor.

On other point. Is there any serious question—with reference to what points need to be briefed, is there any serious question in the Court's mind as to the deductibility of interim interest—the interest on the interim financing?

The Court: I am leaving all issues open and see what benefit I get from the work of the attorneys.

Mr. Sayre: Excuse me, Your Honor. You made the finding there was no loan of the $500,000.00. That would eliminate the accrual of interest issue; is that correct?

The Court: Well, I am not eliminating any issue. I am simply saying that if I know what a loan is, which is where one party gives to another party certain money to use for a certain period of time and expects it back at some time, [11] usually in return for a certain so-called interest or money in consideration for the use thereof, there is no legal obligation for either of those items: to repay principal or any interest, as such.

All right.

Court will be in recess.

* * *

at the end of any subsequent option period.[2] Absent action by Worthen, there is no way that plaintiff can obtain repayment of the so-called "loan".

Plaintiff holds the legal title to the building under Arkansas law and is for tax purposes, too, the owner thereof. It bears the burden of depreciation and obsolescence.

The defendant does not contest the unreasonableness of the rental charge for the building. The Court has already indicated in open court that the reasonableness of the annual rent under the ground lease was really immaterial because under the arrangement it was essentially a wash-out item.

The plaintiff had mixed motivations for wanting to enter into the transaction, in addition to receiving the benefits of the tax shelter involved: in addition to the good after-tax rate, the plaintiff had a need to diversify its holdings and a need to use its accumulated earnings. There was also the long-term return on the investment which could be expected when the mortgage indebtedness was retired.

At this time I direct the attorney for the plaintiff to prepare and submit to the defendant, for its approval as to form, a precedent judgment in conformity with this letter-memorandum and the factual findings and legal conclusions stated in open court at the conclusion of the case. The Court will also *consider* making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975. The precedent judgment shall be submitted by June 4, 1975.

Yours very truly,

/s/ G. Thomas Eisele
G. Thomas Eisele

[2] Worthen's future capital requirements and the option prices stipulated on the one hand and the reasonable rentals stipulated on the other make this quite clear. Because of the unlikelihood, the improbability, that the option will be exercised, there is no basis to the Government's contention that it is acquiring an equity in the property through its payment of rent.

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Supplementary Findings of Fact and Conclusions of Law

(Filed June 11, 1975)

In open court at the end of the trial and by Letter Memorandum of May 16, 1975, the Court made certain findings of fact and conclusions of law in this proceeding. In the Letter Memorandum of May 16, the Court indicated to the attorneys for the parties that it would "consider making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975." The plaintiff submitted "Proposed Findings of Fact and Conclusions of Law" prior to May 30, 1975. Defendant has submitted none.

Although the Court usually does not make findings with respect to uncontested or noncontroverted facts such as those contained in the "Proposed Findings of Fact" 1 through 7 and 10 through 13, it will supplement its findings of fact in this case by adopting said proposed findings since the facts stated are true and were never really at issue in the case. The Court has already made findings of fact in the matters referred to in "Proposed Findings" numbered 8 and 9. The proposed findings are accurate, but are simply a restatement of the facts previously found by the Court.

The "Proposed Conclusions of Law" submitted by the plaintiff are accurate statements insofar as they refer to the law involved, but most of the proposed additional conclusions are unnecessary in the light of the Court's rulings. The Court will, however, adopt "Proposed Conclusions"

numbered 4, 6, 8, and 9 as supplements to, or a further statement of, its prior conclusions.

For the purpose of identifying the supplementary findings of fact and conclusions of law proposed by the plaintiff, the Court attaches hereto, and makes a part hereof, the submission by the plaintiff entitled "Proposed Findings of Fact and Conclusions of Law".

Judgment will be entered this date pursuant to the rulings in open court, the Letter Memorandum of May 16, 1975, and the findings of fact and conclusions of law adopted herein.

Dated this 11 day of June, 1975.

/s/ GARNETT THOMAS EISELE
Garnett Thomas Eisele
United States District Judge

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

(Caption Omitted in Printing)

Proposed Findings of Fact and Conclusions of Law

FINDINGS OF FACT.

1. During 1965, Worthen Bank & Trust Company ("Worthen") began to plan the construction of a new multistory bank and office building to replace its old bank building in Little Rock, Arkansas. About the same time Union National Bank of Little Rock ("Union") also began to plan the construction of a new bank and office building. Adjacent sites were acquired by both banks on Capitol Avenue, separated only by Spring Street. It became a matter of competition and prestige between the two banks as to which bank would start and complete its building first.

2. Worthen initially planned to finance the estimated $9,000,000 cost of its site, new building and parking facility by selling $4,000,000 of debentures and using the proceeds to purchase $4,000,000 of capital stock of a wholly owned real estate subsidiary, which would then raise the remaining $5,000,000 through [-2-] a conventional mortgage loan on the new premises. This plan was abandoned for two reasons. As a bank chartered under the laws of Arkansas, Worthen could not pay more than the then statutory limit of 6% on any debentures it might issue, and Worthen was unable to locate a purchaser of the proposed $4,000,000 of debentures at an interest rate of 6% or less. Further, under the provisions of Section 24A of the Federal Reserve Act, prior approval of the Board of Governors of the Federal Reserve System was required if the total investment in bank premises (including any investment in a real estate company holding title to the premises) exceeded

Worthen's capital stock of $4,000,000, and Worthen was informed by staff employees of the Federal Reserve System that they would not recommend approval of the plan by the Board of Governors.

3. Worthen then proposed a new plan involving a sale and leaseback. Both the Federal Reserve Bank of St. Louis and the State Bank Department approved the new plan after required modifications, including a requirement by the State Bank Department that Worthen have an option to repurchase the building after 15 years. Thereafter Worthen conducted detailed negotiations with several investors, including Goldman, Sachs & Co., Eastman Dillon, Union Securities & Co., Stephens, Inc. and plaintiff, resulting in the preparation by Worthen of a "Specification For Sale—Leaseback of Worthen Bank and Office Building", which incorporated the best features from Worthen's point of view of the proposals made by the various investors. These specifications were submitted to Stephens, Inc. and plaintiff was accepted when plaintiff improved its bid by reducing the [-3-] proposed rent $21,000 per year for the first 5 years.

4. Because of its race with Union to complete construction first and prior to the selection of the investor, Worthen obtained a verbal commitment from First National City Bank for interim financing and from New York Life Insurance Company for permanent financing, subject to the lenders' approval of the investors to be selected. Worthen also negotiated a cost-plus construction contract with the general contractors prior to the final selection of the investor. After plaintiff was selected as the investor, plaintiff, Worthen, New York Life and First National City Bank spent five months in hard arm's length negotiations and drafting before finalizing the documents reflecting the agreements between the parties.

5. Worthen leased to plaintiff for 76 years and 7 months the ground under the bank building, sold the building

piecemeal to plaintiff for $7,640,000 as it was being constructed (to meet the requirement of the Federal Reserve Bank that the building not appear on Worthen's books), and then leased back from plaintiff the completed building for a primary term of 25 years, with options to extent the lease for 8 additional terms of 5 years. Plaintiff invested in the building $500,000 from its own working capital and $7,140,000 it borrowed from New York Life Insurance Company on the permanent loan.

6. The annual rent of $582,224 for the first 11 years of the building lease and $613,156 for the next 14 years is the exact amount required to amortize the New York Life loan during the 25-year primary term of the lease. The rent on the building during the option periods totaling 40 years is [-4-] $300,000 per year. The evidence reflected and the Court finds, that the rent to be paid by Worthen during the term of the lease is reasonable, a fact not contested by the defendant.

7. Worthen was given the option to purchase the Worthen Building on the following dates at the following purchase prices:

11-30-80 (after 11 years)	$6,325,169.85
11-30-84 (after 15 years)	5,432,607.32
11-30-89 (after 20 years)	4,187,328.04
11-30-94 (after 25 years)	2,145,935.00

The option price at each date represents the unpaid balance of the New York Life note plus plaintiff's $500,000 plus 6% compounded interest. It also represents the negotiated estimate of plaintiff and Worthen as to the fair market value of the building on the option dates, which the Court finds to be reasonable. The defendant produced no witnesses to contest the reasonableness of the option prices.

8. There has never been any understanding or agreement between Worthen and plaintiff that Worthen will ever exercise any of its options to purchase. Because of Worthen's future capital requirements, the very substantial amounts of the option prices, the reasonableness of the net rents Worthen will be required to pay during the original and extended terms of the building lease and the economic return Worthen earns on its funds not invested in real estate, it is most unlikely and improbable that Worthen will exercise its options to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods.

9. The ground lease requires plaintiff to pay Worthen $50.00 per year for the first 26 years, 7 months (the length of the primary term of the building lease plus the construction period). Thereafter the annual rental under the ground lease [-5-] will be as follows:

12-1-94 thru 11-30-99 (5 years)	$100,000.00
12-1-99 thru 11-30-04 (5years)	150,000.00
12-1-04 thru 11-30-09 (5 years)	200,000.00
12-1-09 thru 11-30-34 (25 years)	250,000.00
12-1-34 thru 11-30-44 (10 years)	10,000.00

The government contends that the ground rent of $50.00 per year during the primary term of the building lease is unreasonably low and indicates that Worthen owns the building. The evidence clearly showed, and the Court finds, that the amount of the ground rent during the first 25 years of the building lease is immaterial: had the ground rent to be paid by plaintiff to Worthen been increased, the building rent to be paid by Worthen to plaintiff would have been increased by the same amount, resultng in a washout.

10. On an audit of plaintiff's income tax return for 1969, the Commissioner of Internal Revenue determined, without further explanation, that plaintiff is "not the owner for

tax purposes of any portion of the Worthen Building. Therefore, the income and expenses related to this building are not allowable to you for Federal income tax purposes." Based upon this determination the Commissioner made the following adjustments to plaintiff's reported income:

1. Accrued rental income for 1 month from Worthen		$(48,527.01)
2. Accrued interest for 1 month owed to New York Life		40,162.50
3. Depreciation for 1 month on Worthen Building		51,618.79
4. Expenses during construction:		
(a) Interest paid to FNCB	$403,899.54	
(b) Legal expense	33,351.05	
(c) Title insurance	10,140.00	
(d) Audit expense	3,475.00	
(e) Telephone and travel	801.16	451,666.75
5. Accrued interest income		2,298.15
Total increase in reported income		$497,219.18

[-6-] 11. Based upon these determinations, the Commissioner assessed an income tax deficiency against plaintiff in the amount of $236,596.36, together with interest in the amount of $43,790.84, making a total deficiency assessment of $280,387.20. (This figure does not include other uncontested adjustments which are not involved in this case). Plaintiff paid the deficiency assessment and filed a claim for refund of the $280,387.20, which claim the Commissioner disallowed. Thereafter plaintiff filed this action to recover the $280,387.20, with interest.

12. The Gevernment contends that, although the "form" of the transaction was a sale and leaseback arrangement,

in "substance" Worthen owned the building; that plaintiff was a mere "conduit" of the interim loan from First National City Bank to Worthen and of the permanent loan from New York Life Insurance Company to Worthen; and that plaintiff "loaned" to Worthen the $500,000 which plaintiff invested in the building from its own working capital.

13. The plaintiff contends that for Federal tax purposes the transaction was in "substance" exactly what it was in "form", i.e., a true sale and leaseback transaction, with the interim and permanent loans being in from and substance made to plaintiff rather than to Worthen.

CONCLUSIONS OF LAW

1. It was both the "subjective" and "objective" intention of the parties, as evidenced by their written agreements when read in the light of the attending facts and circumstances existing at the time the agreements were executed, that the transaction [-7-] be a sale-leaseback with options to repurchase, exactly in accordance with the form and language of the documents evidencing the transactions. Any other view of the case would not only produce strange and untenable results but would be both unjust to plaintiff and contrary to the intent and purposes of the applicable federal tax laws. *Western Contracting Corporation* v. *Commissioner,* 271 F.2d 694 (8 Cir. 1959); *Arkansas Bank and Trust Company* v. *United States,* 224 F. Supp. 171 (D.C. Ark. 1963).

2. Plaintiff owns the Worthen Building, both under Arkansas law and for federal income tax purposes. Because of the improbability that plaintiff will exercise any of its options to purchase, there is no basis for the defendant's contention that Worthen is acquiring an equity in the property through the payment of rent. Since the parties in good faith actually intended to enter into a sale-leaseback transaction, Worthen will acquire an equity in the

property only if and when it ever exercises any of its options to purchase. Until the option to purchase is exercised, plaintiff bears the burden of the depreciation and obsolesence of the building. Defendant did not question the method or rate of depreciation used by plaintiff. Plaintiff is entitled to deduct the depreciation claimed on the building in its 1969 return. *Breece Veneer and Panel Company* v. *Commissioner,* 232 F.2d 319 (7 Cir. 1956); *Benton* v. *Commissioner,* 197 F.2d 745 (5 Cir. 1952); *Kearney & Trecker Company* v. *United States,* 195 F. Supp. 158 (ED Wisc. 1961).

3. Plaintiff was not a mere "conduit" for loans to [-8-] Worthen by First National City Bank and New York Life Insurance Company, as contended by the defendant. Plaintiff was the borrower and sole obligor on the loan and on the permanent loan. The interim and permanent lenders made independent investigations of plaintiff's financial stability, negotiated with plaintiff for almost six months over the details of the loans and in all respect intended and treated plaintiff as the borrower. The fact that Worthen negotiated tentative commitments for the loans prior to the selection of plaintiff as the investor does not indicate that Worthen was the borrower; it simply enabled Worthen to attract more potential investors and to obtain a lower rent. The fact that the rents were no less than the amount required to amortize the permanent loan was a requirement of New York Life Insurance Company; the fact that the rents were no more is only a reflection of the relatively small initial equity required of the investor and of the intensity of the competition among the potential investors for the investment. Plaintiff is entitled to deduct the interest paid and accrued on the interim and permanent loans.

4. Plaintiff is entitled to allocate and deduct its expenses incurred in obtaining the interim loan and permanent loan over the lives of the respective loans to which they relate.

Detroit Consolidated Theatres, Inc. v. *Commissioner*, 133 F.2d 200 (6 Cir. 1943); *Anover Realty Corp.*, 33 T.C. 671 (1960). Plaintiff is entitled to allocate and deduct over the life of the building the expenses incurred in acquiring the building. Plaintiff and defendant have stipulated the proper allocation of such expenses.

[-9-] 5. Even if the Court had found that Worthen owned the building for federal income tax purposes and was entitled to the depreciation deduction, plaintiff would still have been entitled to deduct the interest it paid on the interim and permanent loans and to allocate and deduct the expense it incurred in obtaining the interim and permanent loans and title to the building. *Rev. Rul. 72-543.*

6. The theory of the defendant that plaintiff "loaned" $500,000 to Worthen is completely untenable, both in fact and in law. There was no obligation or agreement by Worthen to repay the $500,000 and no way plaintiff could force the repayment. The only way plaintiff could ever receive the $500,000 from Worthen would be through the exercise by Worthen of one of its options to repurchase, an event entirely within the discretion of Worthen and highly improbable. Consequently, the Commissioner erred in assuming that Worthen will exercise its option at the end of the eleventh year of the building lease, and in determining that plaintiff's anticipated $303,356 gain on the assumed exercise of the option is the equivalent of interest which plaintiff must accrue as income evenly over the first eleven years of the lease. Regulations 1.446-1(c)(ii).

7. The defendant placed considerable emphasis upon the fact that, assuming plaintiff exercised its option to purchase at the end of the first eleven years of the lease, plaintiff's deduction for depreciation on the building would generate an operating loss deductible against other income of plaintiff which would result in the net tax saving to plaintiff of $312,220.45 over the eleven year period. (Defend-

ant's Exhibit 6). Defendant [-10-] argued that plaintiff's only reason for investing in the building was to obtain this tax saving, and that a device to minimize tax liability, with no additional business purpose, will be disregarded for tax purposes. Defendant's argument on this point is in error for several reasons. First, the evidence clearly reflects, and the Court finds, that plaintiff was motivated to enter into the transaction, not only because of the good current after-tax return offered by the investment, but because of plaintiff's need to diversify its holdings, the need to use its accumulated earnings to avoid a Section 531 tax, and the anticipated long-term return on the investment after the permanent loan was retired. Secondly, the form of the transaction was determined by Worthen within guidelines established by banking law restrictions having nothing to do with tax motives; substantially the same terms had been negotiated with other potential investors before plaintiff entered the picture. The reality of the transaction for tax purposes cannot be unilaterally determined solely by plaintiff's intent or motives. *Breece Veneer and Panel Company* v. *Commissioners*, supra, at 323. Thirdly, it is highly unlikely that the option will be exercised at the end of the first eleven years of the lease, after which time the building lease will generate a substantial taxable income to plaintiff. Finally, the fact that plaintiff will receive a tax benefit during the early years of the investment is in keeping with the intent of Congress to stimulate investments in depreciable real estate through accelerated depreciation deductions: it does not suggest that [-11-] the substance of the transaction was not in keeping with its form. Plaintiff has the legal right to decrease the amount of what otherwise would be his taxes by means which the law permits. *Gregory* v. *Helvering*, 293 U.S. 465 at 469 (1935).

8. The agreement of Worthen, as lessee under the Building Lease, to pay all taxes, insurance and maintenance on the building, to hold the lessor harmless from all claims

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

Notice of Appeal

(Filed August 11, 1975)

Notice is hereby given that the United States of America, defendant herein, appeals to the United States Court of Appeals for the Eighth Circuit from the judgment entered in favor of plaintiff on June 11, 1975.

UNITED STATES OF AMERICA
/s/ W. H. DILLAHUNTY
By W. H. Dillahunty
United States Attorney

(Certificate of Service Omitted in Printing)